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The Code of Conduct
TNCs in the world economy

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Editorial Note

The opinions expressed in this publication are those of the authors and do not necessarily reflect the views of the United Nations Centre on Transnational Corporations.

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THE CODE OF CONDUCT

Since negotiations on the Code of Conduct on Transnational Corporations began in the late 1970s, the world economy has undergone a number of important changes. To assess the impact of those changes on the elaboration of international standards concerning the relations between Governments and TNCs, a number of experts in the field of international economic law gathered at the Peace Palace, The Hague, on 15 and 16 September 1989. The focus of the Symposium was on the main outstanding provisions in the draft Code. The general sense of the Symposium on those issues was reflected in a number of suggestions made by the participants. These are reproduced below, along with articles which examine various aspects of the changes that have taken place.

Another recent development significant to the Code negotiations relates to the shift in investment patterns experienced in some countries, since this could affect alignments on TNC-related issues. Some of the objectives related to the Code raised in the past are now becoming increasingly important policy concerns for such countries as the United States that are progressively receiving larger inflows of foreign direct investment. That theme was prominent among the considerations that led the Committee on Foreign Affairs, Subcommittee on Human Rights and International Organizations of the United States Congress, to hold hearings on the Code negotiations. Excerpts from the testimonies at the hearings are reproduced throughout this section.

With the outcome of those efforts as a background, the Bureau and the Enlarged Bureau of the special session of the Commission on Transnational Corporations met in New York from 23 to 25 January 1990 to decide on the future of the Code. After considering various alternatives, the Bureau agreed to recommend that the Code negotiations should be concluded as soon as possible, on the understanding that further negotiations would entail only minor changes in the present (1988) text and would conclude before July 1990. In the course of the enlarged Bureau consultations, the developed countries identified a number of provisions in the Code which, in their view, needed to be refined. The Enlarged Bureau decided to hold further consultations in New York from 2 to 6 April and on 22 and 23 May 1990 with the aim of concluding the work on the Code of Conduct on Transnational Corporations. Following those consultations, the special session will be reconvened for the last time on 24 May 1990 to receive and formalize the conclusions of the Enlarged Bureau on the Code of Conduct, and to transmit them to the Economic and Social Council in time for its 1990 summer session.

Congressional Hearings on the Code

On 15 November 1989, the Subcommittee on Human Rights and International Organizations of the Committee on Foreign Affairs, United States House of Representatives, held hearings on the status of negotiations on the United Nations Code of Conduct on Transnational Corporations. The hearings were chaired by the Honourable Gus Yatron (Democrat-Pennsylvania).

The following witnesses presented oral testimony: Jane Becker, Deputy Assistant Secretary, Bureau of International Organizations Affairs, United States Department of State; Esther Peterson, Representative of the International Organization of Consumer Unions to the United Nations; Seymour J. Rubin, Professor of International Law, Member of the State Department Advisory Committee (on transnational corporations) and United States representative to the United Nations Commission on Transnational Corporations from 1975 to 1987; David C. Gill, Member of the Committee on Multinational Enterprises and International Investment of the United States Council for International Business. In addition, written statements were submitted by John M. Kline, Deputy Director, Karl F. Laddegger Program on International Business Diplomacy, School of Foreign Service, Georgetown University; John B. Rhodes, Vice Chairman, Booz, Allen and Hamilton Inc., formerly Chairman of the Business Industry Advisory Committee to the Organisation of Economic Co-operation and Development (OECD); Oscar Schachter, Professor of International Law, Columbia University Law School; and Sidney H. Willner, former Vice Chairman of Hilton International Co. Excerpts from the testimony are presented separately.

A new environment for the Code*

By John M. Kline

John M. Kline
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The debate over a United Nations Code of Conduct on Transnational Corporations was born in fiery oratory in the early 1970s. Almost a decade and a half later, a text lies nearly complete, waiting for agreement on only a few remaining issues. As the 1990s open, the beginning of a new decade provides an appropriate time for the conclusion of the Code. Changing political, economic and business circumstances have lent new impetus to the TNC debate. The significance of old disagreements needs to be re-examined, since many original perceptions might no longer apply in the same way, and pressing new needs have arisen. To achieve the original objectives and address emerging challenges, first the Code negotiations must be brought to an early conclusion. Freed from the heavy emotional baggage of earlier controversies and with a renewed political commitment, Governments can dismantle negotiating barriers that are now more symbol than substance, breaking the impasse that has kept United Nations Code discussions on hold over the past decade.

Breaking the political impasse

The Code negotiations are caught in a time warp that reflects political concerns about TNCs as they operated in the 1960s and 1970s. The first step towards achieving progress on the Code is to break this impasse by minimizing the debate over issues rooted in past controversies, focusing instead on co-operative objectives and procedures that would follow the adoption of the Code and would address new geopolitical developments and economic realities.

Issues that stimulated Governments to undertake the Code exercise peaked in the mid- to late 1970s. Much of the hostility towards TNCs was founded on fears of potential TNC interference in domestic political affairs—a concern seemingly confirmed by the ITT incident in Chile. Developing countries were just emerging from the bonds of colonialism and lacked experience for direct dealings with global enterprises. In part, the Code exercise has already helped improve that situation, opening the "black box" surrounding TNC operations and improving the capability of Governments of host countries to bargain with those corporations.

The changing political context for the Code discussions is reflected in the dramatic decrease in expropriation disputes. During a quarter century of active TNC expansion from 1960-1985, almost two thirds of expropriations occurred in just the middle seven-year period from 1970-1976. It is no wonder, then, that expropriation/compensation issues and the debate about relevant international law principles and practices became a major point of contention in Code discussions. After the 1975 peak of 83 incidents in 28 countries, the number was halved the following year and dropped to 15 in 1977. In the 1980s, expropriations continued to decline, averaging less than three acts per year.[1]

On one level, the near disappearance of expropriation incidents offers *prima facie* evidence of the decreasing importance of this controversy. Even more convincing are developments that appear to account for the declining expropriation figures, including both corporate techniques to reduce, manage or offset potential expropriation risks, and changing governmental policies that decrease the attractiveness or need for expropriation actions.

Those changes have not yet translated into progress on a few Code issues, however, especially the different approaches over appropriate references to international law. Government officials and business representatives who have invested nearly a decade advocating their positions on principles find it difficult to step aside from that debate long enough to reassess whether their formulations, based on past fears and conflicts, really correspond to current political and business realities.

The time has come to adjourn debates rooted in emotional historical controversy. Underlying political dynamics have changed enough since the mid-1970s so that progress is now possible. The remaining negotiating obstacles can be overcome, as was demonstrated by the ability of a diverse group of expert advisers to the Commission on Transnational Corporations to agree on approaches that could resolve remaining Code issues.[2]

Unfortunately, the Code debate on those issues has become so divorced from operational reality in recent times that the attention of most Government representatives and international business leaders has shifted elsewhere. The exercise simply lost momentum as the issues being debated lost their effective meaning. The missing component in translating potential compromises into negotiating success appears to be the political will to call a halt to past rhetoric, focusing instead on the Code objectives that look forward rather than backward. This political will may yet be found if an assessment of the changing international environment demonstrates the relevance and benefits of the Code.

* This article draws upon a study entitled *The New Code Environment* (UNCTC, *Current Studies*, Series A, No. 16) (forthcoming)) that the author recently completed for the Centre.

[1] UNCTC, *Transnational Corporations in World Development: Trends and prospects* (United Nations publication, Sales No. E.88.II.A.7), p. 315.

[2] The statement of the Expert Advisers has been reproduced in *The CTC Reporter*, No. 20 (Autumn 1985), pp. 18-19.

READEX

The new code environment

The need and relevance of the Code today are explained by the significance of the role of TNCs in the world economy. TNCs have become the lynchpin for world economic activity, particularly in the most dynamic sectors of information-based technology and services. TNCs act as a vehicle for organizing and integrating trade, investment and monetary transactions across national borders. Technologial advances allow, and competitive pressures require, that enterprises "go global".

This phenomenon has two important implications for the rationale of the Code debate. First, political leadership must begin to deal with international economics more as a unified whole rather than addressing it only in separated institutions or compartmentalized policy segments divided according to trade, investment and monetary issues. TNCs, as the major organizational vehicle of that integration, must be a central part of such policy considerations. The Code provides a framework that combines an integrated view of macro-economic issues with applied micro-level TNC operations.

Second, the world community must address an emerging economic and geopolitical pattern that threatens to arrest full economic interdependence by splitting the globe into even more isolated blocs which, under the influence of increasingly rapid technological change, can speed away from one another at an exponential rate. Without conscious policy steps to encourage economic linkages between developed and developing countries, the large majority of the world's population will be consigned to a politically unstable and ethically unacceptable state of permanent "underdevelopment".

Again, TNCs, as the primary vehicle for functional economic integration, can play a constructive linking role, if provided with an appropriate guiding international framework. Such a framework should address both governmental and business responsibilities in the international economic system, a principle that is already broadly accepted in the Code.

While originally associated with criticism of TNCs, it actually seeks balanced and positive objectives that maximize the benefits of TNCs' activities, while minimizing potential conflict and negative impacts. The growing significance of TNCs in the world economy increases the importance of concluding an international code to promote and guide TNC functions, particularly in mobilizing the capital, skills and technological resources needed to meet world growth and development needs.

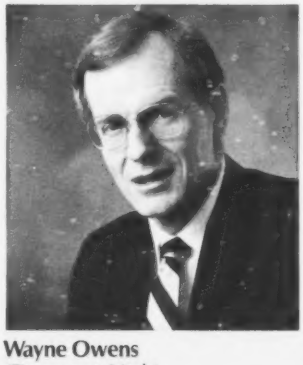
Macro-economic changes and challenges

The major portion of world trade and finance flows within, between or among TNCs, whose networks are organized through the vehicle of foreign direct investment. Significant changes are occurring in the origin and destination of new foreign direct investment, thereby altering the make-up and distribution of the TNC community. Cross-investment trends among the developed nations create the basis for a more common policy outlook. Conversely, most developing countries are attracting less foreign direct investment, which could further isolate them from dynamic growth sectors of the world economy.

The developed nations most singularly identified as home and host countries at the beginning of the 1970s—the United States and Canada, respectively—have become more balanced in inward and outward direct investment. The United States now grapples with issues of increased foreign ownership in its economy rather than promoting only home-country positions. Historically the world's top supplier of direct

Hearings on the Code:

Statement by the Hon. Wayne Owens



Wayne Owens
(Democrat-Utah)
Subcommittee on Human Rights and International Organizations

Over a decade ago, then-United States Secretary of State Henry Kissinger, among others, advocated an international rule of law regarding foreign investment; the need today for such an effort is significantly more compelling than it was in the early 1970s.

Foreign direct investment has grown substantially in recent years and is one of the most important factors contributing to world economic growth. While the total value of foreign direct investment approaches one trillion dollars, there is no international framework to address the myriad of issues that such activity creates.

The United Nations effort to attempt to establish a régime to deal with relationships between sovereign States and transnational corporations is certainly warranted, and is consistent with the Organization's mandate by which GATT, the IMF and the World Bank were created.

I think that a properly crafted Code of Conduct for Transnational Corporations has the potential to provide some very significant benefits to developing countries, the industrialized nations, the business community, and the world's consumers, and is consistent with United States interests.

Such a Code could ensure a liberal and open system of foreign direct investment, thereby promoting world economic growth. By providing guidelines for appropriate corporate conduct, as well as for fair and equitable treatment of transnational corporations by host countries, the Code can reduce frictions and foster an improved investment relationship between the Governments and corporations. Further, a sound Code could help address important global environmental and consumer concerns, which are becoming increasingly important. It could also contribute to the development of international law.

Some of the issues which remain to be resolved are critical to our country's interests. They involve nationalization and compensation, permanent sovereignty over natural resources, the treatment of transnationals in host countries, how disputes between countries and transnational corporations are to be handled, the applicability of customary international rules, and how to uphold the principle of non-interference of transnational corporations in the internal political affairs of States while promoting and preserving open government.

For those reasons, our country needs to play a leadership role, with a constructive and enlightened policy in the Code negotiations. I hope the administration will actively work to bridge the remaining differences so the benefits of the Code can be realized and to ensure United States interests are preserved. Obviously, a poorly drafted Code could present some serious dangers and can be avoided within an administration that remains engaged throughout the process. The previous Administration was criticized as being inflexible and unwilling to work for the completion of the Code.

I will be deeply interested in hearing the Bush Administration's policy regarding the Code of Conduct for Transnational Corporations, the concerns of the business community and the views of the consumer interests.

investment capital and home to the largest number of TNCs, the nation is attracting progressively larger inflows of funds. By 1988, cumulative foreign direct investment in the United Sates equalled that of United States-based TNCs invested abroad.

While Europe moved somewhat out of balance at the beginning of the 1980s, the reinvigoration of the European Community through the 1992 project has readjusted that trend. Meanwhile Japan, the newest major foreign investor, is being put on notice that it will not be allowed to maintain an unbalanced direct investment position. Reciprocity demands will limit its further investment abroad unless a corresponding foreign investor presence is accepted in Japan.

On the other hand, foreign investment to developing countries has stagnated, concentrating itself in a handful of relatively advanced industrializing nations. The developing world's share of direct investment stock dropped from over 30 per cent in 1967 to roughly a one-quarter share, of which some 86 per cent went to only 18 developing countries and territories in the 1980s.[3]

Technological change accounts for some of the reduced attractiveness of many developing countries as a production site for foreign investors. Discoveries in new materials and processes lower the demand for many raw materials, while automation and quality-control requirements make unskilled and semi-skilled labour a relatively less important component of manufacturing costs. While losing those production advantages, most developing nations also lack large enough internal markets to justify local production sites based on domestic sales potential. In fact, as cross-investment brings new threats to TNC home markets, corporations may concentrate their resources there even further, battling foreign rivals in the major established markets rather than exploring new markets in the developing world.

Those competitive dynamics, and their impact on geopolitical alignments, establish part of the environment for the Code discussions. Developed countries face a stronger imperative than in the mid-1970s to reach new agreements on investment-related issues and their more balanced cross-investment positions may forge enough common ground to achieve positive results. Developing countries, which entered TNC debates anticipating that growing natural resource power would help shrink the gap between the developing and developed world, saw their prospects diminish as the commodity leverage waned and technological imperatives increased in the foreign investment community. Many nations find themselves in an even weaker position than before, saddled with heavy external debts that drop them farther and farther behind the new configuration of technologically and economically advancing nations.

A TNC metamorphosis

Transnational corporations now come in all shapes and sizes from many different countries, supplying an evolving array of products and services through complex but fluid business arrangements. Those changes diffuse corporate power and weaken the presumed ability of TNC management, or single national Governments, to direct and control the full impact of business activity.

Competition and technological developments are forcing even the largest TNCs into strategic intercorporate alliances. Cost marketing and political considerations often lead to the choice of alliance partners from different countries, thereby mixing the national identity of the business ventures.[4] This increasingly mixed national character

[3] UNCTC, *Transnational Corporations in World Development*, *op. cit.*, p. 80.

[4] For a more detailed explanation and illustrations of intercorporate alliances, see John Kline, "Inter-MNC alliances", *The Washington Quarterly* (Fall 1985), pp. 57-71, and "Trade competitiveness and corporate nationality", *The Columbia Journal of World Business* (forthcoming).

Hearings on the Code:

Excerpts from the testimony of Jane Becker

...The draft Code's section on the activities of transnational corporations, much of which was agreed *ad referendum* in the late 1970s, is not consistent with the trend towards liberalization. Rather, it is steeped with the economic thought prevailing in many developing countries in the 1970s: Governments should set economic objectives and businesses should carry out those objectives. For example, paragraph 10 of the 1987 draft states that "Transnational corporations should carry on their activities in conformity with the development policies, objectives and priorities set out by the Governments of the countries in which they operate and work seriously towards making a positive contribution to the achievement of such goals..." In our view, the draft Code has fallen behind the times.

The draft's section on the activities of corporations is also somewhat at variance with the position of the United States in the Uruguay Round of Negotiations on Trade-Related Investment Measures (TRIMs), which distort trade and investment flows to the detriment of United States business. In those negotiations, the United States is seeking disciplines on the use of TRIMs, which in our view include, among other things, local-equity requirements, local-content requirements, export requirements and technology-transfer requirements. Yet the draft Code implicitly endorses the use of TRIMs:

—The draft calls on TNCs to co-operate in "the implementation of national objectives for local equity participation".

—The draft implicitly endorses the use of transfer-of-technology requirements.

—The draft endorses the use of local-content and export requirements.

In conclusion, Mr. Chairman, let me summarize our views. First, as Assistant Secretary Keyes said in 1987, traditional United States investment policy is that, as a basic rule, market forces rather than government intervention should determine international capital flows, and that foreign investors are entitled to:

—Fair, equitable and, subject to limited exceptions, non-discriminatory treatment;

—Treatment under international law standards, including prompt, adequate and effective compensation, in the event of expropriation;

—The right to transfer profits and capital freely;

—The opportunity for impartial third-party settlement of disputes with Governments of host countries.

The United States Government and the Governments of other developed countries believe the United Nations Code of Conduct for Transnational Corporations must include those points if it is to encourage the flow of foreign direct investment to developing countries. The most recent draft Code does not include these provisions.

Second, we question whether the draft Code's provisions on the activities of corporations are in accord with the temper of the times. Parts, at least, are not consistent with United States efforts in the Uruguay Round to obtain discipline on the use of TRIMs, which impose costs on both developed and developing countries.

of transnational business means that identifying TNC interests with a specific national interest is becoming a more difficult task, with important implications for political alignments in the Code debate.

A related development concerns the growth of low and non-equity foreign investments. A series of Centre reports trace the progressively expanding range of supply and plant leasing or turnkey operations, management contracts, co-production and co-marketing, contract or sub-contract manufacturing, franchising, licensing, and a range of associated joint ventures. Those ventures generally respond to host country political desires, but they are driven at least as much by market-place judgements.

While minimizing the potential financial risk of a TNC that sunken investment can be taken by a host country, lower capital operations also recognize that TNC competitive advantages now often lie less in the provision of investment capital and more in technological applications, managerial know-how, and international market access that may not require an overseas equity stake. Low or non-equity business arrangements based on those advantages also enhance the flexibility of a TNC to respond to changing global conditions—a valuable characteristic in times of rapid change in both products and production processes.

One of the elements most commonly associated with a definition of foreign investment is the foreign investor's equity stake in a local enterprise, which is assumed to reflect the level of foreign control as well as the distribution of resulting business profits. As TNCs emphasize low or non-equity investments and explore flexible arrangements among multiple business partners, the long-term stake of a TNC in any individual host location could thereby be reduced. Without the anchor of substantial invested equity capital, the commitment and sense of responsibility for "good corporate citizenship" in specific locations is likely to weaken.

This conclusion has important implications for the discussion of such issues as ownership, control and benefit-distribution standards. A trade-off seems inevitable between the degree to which a TNC exercises control over a venture and its willingness to make a substantial commitment to the long-term viability and profitability of the venture. A challenge for the effective application of the Code will be to match the Code standards with the new TNC organizational patterns, while exploring ways to enhance TNC stakes in the economic growth and social vitality of host locations, especially in developing country regions.

An expanding issue agenda

Many new problems emerging in the international system are truly transnational in character, both in terms of their impact and the manner in which they must be managed. An obvious example is protection of the environment, which is not divisible territorially since pollution of the air or oceans can quickly spread beyond political boundaries. Specific illustrations include the effect of chlorofluorocarbon production on the ozone layer, the storage and disposal of hazardous waste material, and the effectiveness of product-related health, safety and quality standards. Resolution of those global issues requires co-operation among Governments from both developed and developing countries, as well as the supportive involvement of TNCs.

For example, international problems are emerging in product-related health, safety and quality standards owing to the rapid increase and interdependence of world commerce. In an integrated trading system, the incorporation of sub-standard counterfeit goods in manufactured products, or residue pesticide levels in agricultural produce generate safety and reliability concerns among global consumers. Internationally agreed upon standards and procedures would help avert difficulties stemming from the application of widely varying national criteria, laws and regulations.

While the control of potentially negative impacts is a concern, the facilitation of positive benefits is equally important. A supportive political framework is necessary for the continued growth of global stock markets and securities exchanges, linked data-processing services and media transmission facilities. Similarly, the protection of intellectual property rights, stability of component supply networks and establishment of efficient and effective global marketing and franchising systems require compatible government policies and enforcement mechanisms.

The question is not whether to regulate business, but how to structure co-operative national approaches that facilitate rather than inhibit international business transactions. If a political framework is created without adequate input and attention to encouraging linkages with developing countries, the world community will sacrifice economic efficiency and face a return to increased political confrontation over TNC issues. The Code discussions offer both an

Hearings on the Code:

Excerpts from the testimony of John B. Rhodes

John B. Rhodes

...It would be difficult to argue that the presence or absence of the Code of Conduct will have either an immediate or a decisive effect on international investment. It can be argued, however, that, in an increasingly interdependent world, the existence of such a Code will be a significant force for good, even if only as a reminder of the basic norms of business behaviour and of government behaviour towards business. The history of the OECD Code would tend to substantiate this.

I continue to support the "Expert Advisers" statement as a guide towards successful completion of the Code, noting, as did the Expert Advisers, that the Code will be non-mandatory. I also continue to hold the view that common acceptance of suitable language to provide an "umbrella" clause covering the need to conduct one's affairs—both business and government—in accordance with "international obligations", "accepted international legal principles", or whatever is required. Agreement on such a statement should, under present circumstances, be within the grasp of the negotiators. I am not a lawyer and do not propose to suggest a final wording. The important thing is that the intent is clear and relevant to the rapidly changing world in which we find ourselves. We should not be captive to old rhetoric.

appropriately inclusive political forum for negotiations and an applied perspective on how macro-economic issues interact with micro-level operations in the contemporary world of transnational business.

Prospects

The Code exercise is at a critical juncture. Unless positive action is taken to revitalize the exercise, its lost momentum will soon leave it floundering too far behind changing international conditions. Worthwhile achievements are possible and a window of opportunity exists for forward movement if the parties can break free of old debates and address the needs of the future. The United Nations' unique institutional role should facilitate discussions on a framework for TNCs that will encourage economic growth while minimizing political conflict in a world where global economic forces transcend territorially-bounded policies.

As was suggested earlier, the obstacles remaining in the Code debate are primarily contentious owing to their past history rather than their current relevance. Code discussions must become more than an exercise rooted in past examples of TNC abuse. Earlier discussions attributed to corporate executives a much larger degree of discretion and control than they actually possessed, either then or certainly now in an era of shifting, multi-layered and cross national business alliances. The resulting focus on individual company motivations and actions conveys the wrong priority when measured against the important systemic issues facing the international community.

The concept of TNCs in the Code debate must change to match the expanded and evolved group of enterprises that now crowd under the common umbrella label of "transnational corporation". The key to addressing those enterprises with a code lies with understanding their actions and impact, not with focusing on their national or corporate ownership. If the United Nations Code of Conduct addresses primarily individual unitary corporations, or relies on the unilateral actions of national Governments, it will fail when applied to the growing range of interdependent arrangements among TNCs from different countries.

Directing Code standards to individual corporations will not add up to a framework for the collective business process any more than a truly international set of guidelines will result from scattered bilateral or regional Government agreements. Negotiators should be prepared to adjust their approach, perhaps shifting from individual enterprise standards to industry or business process guidelines. The draft Code of Conduct on Transnational Corporations could be turned into a code of conduct for transnational business. Conceptually, this change reflects a broader process orientation, recognizing that the global economy operates through the collective interaction of Governments and businesses. Rather than seeking prescriptive standards of conduct to be applied on individual firms, follow-up actions under this code concept would focus on a co-operative commitment to use United Nations institutions to explore the means and methods for dealing with the political as well as economic dimensions of comprehensive global issues.

The image of "an enterprise" still pervades in some quarters, even though the actual wording of the draft text accommodates all the evolutionary developments among TNCs. The accepted definition goes beyond the simple model of a unitary enterprise centrally controlled by a single parent company. By allowing for "one or more decision-making centres", the language incorporates the growing linkages among enterprises based on an ability to exert significant influence over such activities as sharing knowledge, resources and responsibilities.[5] The conceptualization of policies on TNCs must therefore change in a parallel fashion to match the evolved and expanded group of enterprises that now crowd under the common umbrella label of "transnational corporation".

Once adopted, follow-up code discussions could look forward to the identification and resolution of common problems in areas such as environmental protection, worker and product safety, banking and securities networks and the achievement of sustainable growth in a globally integrated trading system. With international economic processes tied together through TNC networks, the impact of technological change spreads quickly through commercial sectors and geographic regions. The international community needs an institutionalized setting wherein such issues can be confronted early in order to guide those changes while developing ways to soften socio-economic adjustment costs. The major challenge is not to enhance national or even transnational control over individual enterprises, but rather to structure a collective international approach to managing the systemic costs and benefits of a global economy driven by transnational business operations.

The benefits of reaching agreement on the Code must be evaluated in relation to costs of continuing the current stalemate and forgone opportunities if a more co-operative international approach is not established. The accord would mark a shift from the past, away from images and relationship perceptions defined largely by reactions to singular events to a mechanism for follow-up actions that would provide the world community a unique opportunity to enhance co-operative efforts aimed at achieving broadly sustainable growth.

Recently changed political circumstances make progress possible: most developing country Governments recognize TNC benefits; the Government of the United States is more open to United Nations institutional activities; and movement continues on co-operative, issue-specific agreements that address a range of international problems in a variety of multilateral forums. The original objectives are flexible enough to accommodate the new agenda of TNC issues. On the other hand, unless a global framework is established, the Code may simply be bypassed as more cohesive regional collections of countries deal with the issues that most concern them. The danger with this piecemeal approach is that it excludes some affected parties and ignores the ultimate systemic political implications of such actions. If the world community possesses no vision of the future, activity will be defined by the pressures of the present, and those pressures are drawing nations into regional economic blocs that threaten increased political confrontations, especially along a North-South divide. □

[5] See E/1988/39/Add.1, annex, para. 1(a).

The Code and the Uruguay Round negotiations on trade in services

By Arghyrios A. Fatouros

Arghyrios A. Fatouros
Professor of International Law, University of Thessaloniki, Greece

Recent efforts to establish international standards to govern the international movement of services, in the context of the Uruguay Round of Multilateral Trade Negotiations, have taken as their starting point the policies and rules developed in the General Agreement on Tariffs and Trade (GATT) concerning international trade in goods. Another important area, at least as closely related to trade in services, is that of international direct investment. A review of the concepts and standards developed in that context and formulated in particular in the draft United Nations Code of Conduct on Transnational Corporations should provide, therefore, useful insights for the negotiations on trade in services. On the basis of a longer study recently published by the Centre,[1] three principal topics are briefly discussed here, namely, the issue of entry and establishment, the application of agreed legal standards and the role of economic development.

Entry and establishment

1. Control over entry

No "open door" principle exists in international customary law. The traditional rule, repeated in numerous treaties and other international instruments, is that a State is fully competent to decide whether it will admit in its territory foreign goods, services and investments, and to determine the conditions for such admission. That principle is expressly formulated in an agreed paragraph of the draft United Nations Code of Conduct on Transnational Corporations.

> 50. States have the right to regulate the entry and establishment of transnational corporations including determining the role that such corporations may play in economic and social development and prohibiting or limiting the extent of their presence in specific sectors.[2]

Contemporary treaties have introduced a number of qualifications and exceptions to that principle. GATT, for instance, provides for most-favoured-nation treatment, that is, non-discrimination between different foreign States and nationalities, with respect to goods that are at the borders of a member State, before crossing or concerning the crossing of the borders (art. I), and for national treatment once the borders have been crossed and the good are in the territory (art. III).[3]

2. The notion of establishment

The term "establishment" does not have a single, well-defined meaning in international legal usage. It normally connotes the relatively lengthy residence of an alien or a foreign-controlled firm in the territory of another country for the purpose of exercising some economic activity. While "establishment" is not solely connected with investment, it is particularly associated with it, because entry and residence are necessary conditions for direct investment by individuals or companies. In the context of Treaties of Friendship, Commerce and Navigation (otherwise known as "Treaties of Establishment"), the "right" or "freedom" of establishment usually covers the right of an alien or a foreign-controlled enterprise to enter the territory of the State concerned; to reside there; to set up and manage companies; to pursue the economic and other activities expressly listed in the agreement; and, sometimes subject to qualifications, to acquire, own and use property in that State. In most instances, such treaties allow full effect to national regulations concerning the entry of aliens and foreign-owned companies. They contain a series of specific provisions on particular issues, such as the industries in which establishment of aliens and foreign-controlled firms is free or restricted, the modalities of application of foreign exchange controls where they exist, industrial property legislation, taxation etc.

Similarly, most bilateral investment promotion and protection agreements do not provide for a right of entry for foreign direct investment. By stipulating that their provisions apply to investments made in accordance with the laws of the host State, they preserve the latter's right to admit or refuse entry to foreign-controlled firms. In these agreements, however, there is a definite emphasis on encouraging foreign direct investment, in part by facilitating its entry in the host country. A usual clause provides that each party will create favourable conditions for the establishment of investments by the other party and, subject to the powers and criteria provided for in its laws, will admit such investment.

The concept of "establishment" has been the subject of considerable elaboration during the last 30 years in the framework of the European Community. One of the four basic freedoms provided for in the founding treaty of the European Economic Community is that of establishment (art. 52-58). Nationals of member States, individuals or companies have the right to move to another member State and to reside permanently and pursue economic activities in its territory. When so doing, they operate "un-

[1] UNCTC, *Key Concepts in International Investment Arrangements and Their Relevance to Negotiations on International Transactions in Services*, UNCTC Current Studies, Series A., No 13 (United Nations, New York, 1990)(forthcoming).

[2] See "Proposed text of the draft Code", (E/1988/39/Add.1 of 1 February 1988), annex, para. 50.

[3] For the text of the General Agreement on Tariffs and Trade, see United Nations *Treaty Series*, vol. 55, No. 814.

der the conditions laid down for its own nationals by the law of the country where such establishment is effected" (art. 52, EEC treaty). An important body of secondary community legislation deals with the manner in which the right of establishment can be effectively exercised. Of particular relevance to present concerns is the distinction between "freedom of establishment" and the "free provision of services" in European Community law. Both freedoms involve the exercise of a non-salaried economic activity. (Other provisions cover salaried persons and persons crossing the borders between member States for purposes other than the exercise of economic activities.) The principal element that distinguishes establishment from the provision of services is the degree of permanence of the presence of the persons concerned in the host country. If there is no such presence (that is, services are provided by telephone, telex or telefax) or the presence in the territory is temporary (for example, where a lawyer represents a defendant during a trial), the case comes under "provision of services"; if the presence in the territory is permanent, that is, long-term, then it is a matter of establishment. The evident conceptual and practical difficulties in "drawing the line" between the two cases are overcome in part by reference to both freedoms in relevant instruments.

Another forum in which significant developments with respect to establishment have recently occurred is the Organisation for Economic Co-operation and Development (OECD). Its Codes of Liberalisation on Current Invisible Operations and on Capital Movements provide for the removal of major obstacles to the movement of capital, current payments and services among developed market economies. In recent years, the member States' commitment to liberalization has become broader and more effective. While the right of establishment was explicitly excluded earlier from the Code on Capital Movements, a 1984 amendment expanded the definition of inward direct investment so as to cover most facets of establishment. Of particular importance is the provision requiring member States not to maintain policies or practices in regulated industries that raise special barriers to non-resident investors as compared with residents.

3. Degrees of economic presence

Current negotiations on trade in services have brought into light the importance of a dimension of establishment that has long been obscured by the misleading clarity of legal definitions and prescriptions. The presence of a foreign-controlled firm in a host country is a matter of degree. This is true with respect to trade in goods as well as trade in services and investment. Conceptually as well as practically these economic activities blend into one another.

That a foreign firm's presence was a continuum was long recognized not only in

Hearings on the Code:

Excerpts from the statement of David G. Gill

David G. Gill

...A fair, balanced and universal Code of Conduct on Transnational Corporations could do much to enhance a favourable climate which would assist host countries to attract foreign direct investment. This is one of the reasons why the ICC/IOE have co-operated in a positive and constructive manner during the eight years of negotiations in the Intergovernmental Working Group on a United Nations Code of Conduct and, more recently, in the special sessions of the United Nations Commission on Transnational Corporations.

The Commission now faces a crucial stage in the negotiations. Despite the results achieved to date, we must note with concern that the issues where consensus has not been reached cover precisely those principles which the international business community considers essential to underlie a fair and balanced Code which should be universally applicable.

The crucial issues in the view of the international business community are the definition of a transnational corporation, the reference to international law, the principles of fair, equitable and non-discriminatory treatment, and of national treatment, suitable provisions for compensation in the event of nationalization, and provisions covering settlement of disputes and conflicts of jurisdiction.

There is a continuing need for precision and clarity in the wording of the draft Code, if it is to achieve its purpose. Ambiguous or vague clauses to cover up inability to reach consensus must be avoided. Similarly, the deletion of crucial paragraphs or whole sections of the draft Code in order to complete the negotiations would not be a solution.

...A more promising course of action would be the adoption of a completely new approach for the discussions on development and transnational corporations. That approach would, at least for the moment, abandon the ideological battles over the language of the Code which have been provoked by the attempt to force agreement on legal issues where no agreement is presently possible. Instead, the Commission would adopt as its mandate the difficult but necessary task of inventorying the various practical needs of the developing countries *vis-à-vis* transnational corporations. The Commission could act as a clearing-house between the developing countries and the transnational corporations, seeking to develop partnerships for development between the two groups. Such a process would require the efforts of economists and scientists rather than lawyers and politicians. It would require compromises and consultations rather than ultimatums and ideology. Hopefully, it would assist all parties to confront and meet the greatest need of the post-war era: the economic and social development of the developing world.

...Although complete agreement has not yet been reached in the Code negotiations, disagreement is not necessarily a bad thing where fundamental principles are involved. The Code negotiations may be said to have dramatized the need of the developing world for assistance from all sides, including the private sector represented by transnational corporations, in order to move toward economic development. Certainly the negotiations have aided the consciousness-raising of the developed world with respect to the enormous nature of the task at hand. Equally the negotiations have educated all parties, developing and developed worlds alike, as to the sensitivities and difficulties of the tasks that lie ahead. If the world is now better able to move on to concrete practical steps towards assisting economic development of the developing world, one may conclude that the educational preliminaries represented by the negotiations have not been in vain.

textbooks of business administration, but also in the law of taxation: the concept of "permanent establishment" in bilateral treaties for the avoidance of double taxation (normally understood to include commercial operations) was devised in order to take that fact into account. These treaties seek to allocate the income derived from various types of activities by foreign firms for purposes of taxation by the States in which they operate. A principal method for effecting such allocation is to distinguish between types of income and to establish several criteria for linking the income with the State which, according to the Convention, is competent to tax it. One of the criteria is the degree of presence of the foreign firm in the territory of a State. The notion of "permanent establishment" has thus been utilized to refer to the type of presence, the income derived from which is to be taxed by the host State. Both the United Nations Model Double Taxation Convention and the Model Convention on the Avoidance of Double Taxation of Income and Capital prepared by the OECD Fiscal Committee in 1963 and revised in 1977 provide definitions of "permanent establishment" and related terms which are utilized in the great majority of bilateral tax agreements.[4]

A related notion, used in double taxation conventions to deal with income derived from non-industrial and non-commercial activities, primarily income from professional services, is that of a "fixed base". The term is not defined, but is understood to refer to some kind of fixed premises (for example, an office) in the State where the services are performed. It is obvious that, in dealing with this notion, tax treaties are concerned with issues very closely related to those under consideration in the Group of Negotiations on Services.

In dealing with trade in services, the notion of "commercial presence" or "market presence" has acquired particular importance. While some services may be provided across national borders with no need for the presence of the enterprise providing the services within the importing country, in many cases a commercial presence of some degree is necessary. An analogy with trade in goods seems then apposite: the services, like goods, are produced abroad and the local presence merely facilitates their sale. Whereas, however, in the case of trade in goods, the production of the commodities can be relatively easily distinguished from their commercialization (allowing for some conceptual problems which may involve defining the "local content" of products), in the case of services, production and sale are not easily distinguished from one another. It is clear, moreover, that in many cases the presence that is required in the importing country for the effective sale of services involves the flow of production factors (capital, technology, personnel) across borders, and not merely the flow of products (that is, services). The degree of presence in such cases may not always be as advanced as that usually found in cases of foreign direct investment for local production, but it is still far greater than in the typical case of export of goods. The concept of "commercial" or "market" presence is thus still indeterminate, ranging from the kind of presence that may not even involve what in tax treaty terms would be considered a "permanent establishment" to types of presence akin to a full-blown investment-type establishment.

4. Conclusions

In the legal regulation of trade in goods, a clear distinction is made between the treatment of commodities at the border (that is, their entry) and their treatment once they have legally crossed the border. Liberalization with respect to barriers to entry has been the subject of different rounds of GATT negotiations, starting with the lowering of tariffs and the removal of quantitative restrictions and moving to the elimination of non-tariff barriers. Treatment of lawfully admitted products has long been covered by the (GATT) national treatment clause. Questions relating to the entry and presence within the importing country of foreign firms providing the products (for example, the exporter) have generally received less attention, being treated as a side-issue of the basic trade transaction. Questions regarding the degree of actual presence of the foreign supplier within the importing country (its permanence, independent character etc.) have been dealt with primarily in the context of international tax relations and agreements.

In the case of foreign direct investment, the same distinction between entry and treatment after entry obtains, the object of concern being not necessarily the product, but the foreign-controlled firm. Emphasis has long been placed on treatment after entry, that is, once establishment has been permitted. A clear-cut right of establishment has been asserted (albeit still with qualifications) primarily in the case of regional economic integration arrangements. Other international agreements, for example, in the context of the OECD, have been moving in the same direction. In most instruments, the right of the host State to control entry is explicitly recognized.

Current negotiations on trade in services deal by necessity with all of the issues just enumerated: entry and treatment after entry of products (that is, services), as well as entry and treatment after entry of the foreign firms providing the services. The latter is primarily a foreign-direct-investment issue; and there is continuing dispute as to whether it should be dealt with in what are supposed to be essentially trade negotiations. In the case of many types of services, it is difficult, and sometimes impossible in practical terms, to establish barriers to entry at the border. In the absence of tangible products easily distinguishable from their producer, the issue of the entry and after-entry treatment of service-providing firms has been sometimes dealt with together with the preceding issues. The notion of "commercial presence" has been used to account for various degrees of permanent activity of a foreign firm within the importing country. Such presence resembles the types of activity associated with the export of goods, yet often may go beyond it in that a flow of production factors (capital, personnel) is involved. It thus approaches the type of presence associated with investment, that is to say, "commercial presence" blends into "establishment". The types of questions normally associated with private foreign direct investment often arise, *viz.*, capital movements, transfer and implantation of technology, employment, regulation of the professions etc.

Those are no mere academic quarrels over terms and concepts. The issues involved essentially concern policy choices and decisions. Analogies and resemblances are mere aids to analysis with a view to clarifying the policy issues at stake. National and international policies underlying the established legal regulation of foreign direct investment are at least equally relevant with respect to the legal regulation of trade in services under negotiation as the policies relating to trade in goods. Recent efforts at reaching a wider consensus concerning the former (for example, in the negotiations on the draft United Nations Code of Conduct on Transnational Corporations and in the extensive network of bilateral investment treaties) are then of immediate pertinence with respect to the negotiations on trade in services.

Standards of treatment

1. Introduction

To provide for the treatment of foreign products and foreign-controlled enterprises, international instruments usually have recourse to one of three principal standards: the standard of national treatment, that of the most-favoured-nation treatment and the standard of fair and equitable treatment. Other legal standards are also used, although not as frequently as these. Most legal standards are relative (or contingent), in the sense that they do not specify by themselves the rules and principles to be applied, but refer instead to an existing body of rules, which continues to evolve

[4] For the text of the United Nations instrument, see *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (United Nations publication, Sales No. E.80.XVI.3), article 5. The text of the OECD Model Convention is reproduced in OECD, *Draft Double Taxation Convention on Income and Capital: Report of the OECD Fiscal Committee* (Paris, 1977).

Hearings on the Code:

Excerpts from the testimony of Esther Peterson

Esther Peterson

...In the four decades since the Second World War, Mr. Chairman, the United States has lost its position of economic dominance in the world. Where once United States corporations constituted the advance guard in the post-war process of globalizing the world economy, today Japanese and European companies share that role with us. The United States today is not only the world's largest source of foreign direct investment, it is now also the largest recipient of foreign investment. In technology and trade, we are no longer dominant. Though still a super-Power in both areas, the United States must exist in a world of its peers. The Federal Republic of Germany exports more than we do; Japan is a formidable technological force.

These changes in relative economic strength have been reflected in popular perceptions. Where once developing countries—and even the Europeans—were fearful of American transnational corporations assuming dominant positions in their economic life, today, we find alarm in the United States as foreign companies buy up our resources.

...My colleagues tell me that there is a new wave of corporate responsibility in this country. Corporations, our corporations, are willing and eager to co-operate and participate actively in the resolution of many of the problems facing the world and, perhaps more importantly, they want to be seen as good corporate citizens. Well then, why not give them the opportunity to make a useful contribution to the needs and objectives of developing countries, and to the improvement of social and economic conditions world-wide? Why not give them an international instrument to guide these efforts through a constructive and coherent framework?

...I must then wonder why such a Code has not received the enthusiastic and active support of the United States Government.

—The Code endorses the principle of respect for national sovereignty and observance of domestic laws. Is it unreasonable to ask that the affiliates of our corporations observe the laws of the Governments of their host countries?

—The Code calls on transnational corporations to respect human rights and fundamental freedoms. Is it not an American ideal to be a forerunner in the field of human rights?

—The Code requires that transnational corporations carry out their activities in conformity with the development policies, objectives and priorities of the countries in which they operate. Is it not in the interest of our country to promote the development and growth of less developed countries?

—The Code prescribes that transnational corporations abstain from interference in the internal political affairs of host countries.

Arghyrios A. Fatouros *(continued)*

and change over time. In a limited number of cases, absolute (or non-contingent) standards are used, that is to say, the rules to be applied are set out in more or less detail in the instrument itself. Combinations of various types of standards are not uncommon.

2. Fair and equitable treatment

Originally used in the Havana Charter of 1948 (art. 11(2)), then taken up in the Draft Convention on the Protection of Foreign Property proposed by the OECD in 1967,[5] the standard of "fair and equitable treatment" has found favour in recent years in bilateral agreements on investment promotion and protection. It is now referred to in the third Lomé Convention and in the Convention establishing the Multilateral Guarantee Agency (MIGA) (article 12(d)),[6] and has also been included in the draft United Nations Code of Conduct on Transnational Corporations. This standard differs in important respects from other standards in that it does not refer to an established body of law and does not provide specific, absolute rules to which the host State should conform. It is a general, flexible standard, whose principal virtue is the sense of concreteness and specificity suggested by the two adjectives.

The manner in which the fair and equitable treatment standard is used, in particular its relationship to other standards and principles, varies considerably among investment agreements. In some instruments, it is the only general standard used, with references to national and most-favoured-nation treatment directed at specific issues. In other instruments, the fair and equitable treatment standard is used in conjunction with the other two standards. In some bilateral agreements the reference to it stands apart from those to the other standards, while in others a detailed reference to the application of the national and most-favoured-nation treatment standards is followed by a broad reference to the fair and equitable treatment standard.

There is as yet limited practice and arbitral jurisprudence to assist in any attempt to determine the contents of this standard. One possible approach, originally suggested in the Commentary to the 1967 OECD draft Convention and supported by some students of recent bilateral investment treaties, is to see it as covering an array of international legal principles, among them non-discrimination, the duty of protection of foreign property by the host country and the international minimum standard. This approach may be going too far in its search for specificity. Another, more likely approach sees the strength and attraction of the fair and equitable treatment standard in its concreteness and its relative lack of abstract legal content. Both the adjectives used refer not to abstract justice, to legal rules in their clear and rigid form, but to the concrete outcome of the application of legal rules. What it appears to be aimed at is a reference to the prudent and just application of legal rules to particular situations. An invocation of the fair and equitable treatment clause would not necessarily involve a challenge to the abstract legality of the law being applied or to the authority and competence of the organ that has acted; rather it would only evoke the concrete lack of justice (unfairness) of the outcome. In that sense, it may cover cases of unfair discrimination as well as all other kinds of unfair treatment.

Accordingly, the chief usefulness of the reference to this standard in an international instrument would be to provide a relatively easy means for raising questions about the treatment of investors. Reliance on the obligation to accord fair and equitable treatment provides a legitimate, previously agreed upon channel for communication between States and for examination of specific issues. Thus, even in the absence

[5] OECD, "1967 Draft Convention on the Protection of Foreign Property", *International Legal Materials*, vol. 1 (1968), p. 120.

[6] *International Legal Materials*, vol. XXVII (September 1988).

Is it not an American standard to preserve the integrity of the democratic process? Why can we not accept the same standard for other countries?

—The Code requires transnational corporations to contribute to the alleviation of pressing problems of balance of payments and finance of such countries. Is it not in the interest of the United States to support a balanced global economic system?

—The Code prescribes that transnational corporations do not use pricing policies, in their intra-corporate transactions, that are not based on relevant market prices. Is it not an American goal to promote trade practices that reflect the operation of market forces?

—The Code requests transnational corporations not to use their corporate structure and modes of operation to modify the tax base on which their entities are assessed. Is it not the aim of our tax regulations to ensure that taxpayers contribute fairly to the revenue of the country? Why cannot we accept the same principle for other countries as well?

—The Code includes standards for protection of consumers to ensure that the products and processes of transnational corporations do not cause injury to the health or safety of or have detrimental effects on consumers. Is it not an American ideal to work for the well-being of our own citizens and for citizens that receive our products?

—The Code contains also standards for the preservation of the environment and for the avoidance of practices by transnational corporations which are harmful or dangerous. Is this Congress not willing to join actively in taking steps to protect our environment?

...Yes, we do now hear more about multinational corporations; the media announces with great fanfare when a Japanese firm buys an "American" company or when a Saudi business purchases some land in Virginia or when a multinational corporation from the Federal Republic of Germany signs a major contract with a New York company. This media picture in the United States in the last few years has been the long-time staple of media coverage in many African, Asian and Latin American countries. We view these announcements—others view them as well—with a bit of envy, a bit of nervousness, a bit of fascination and a bit of political concern. The change for us in the States is that we are now both major exporters of capital and major importers of capital, both a major home to multinational corporations, and a major host to those firms. We can for the first time appreciate the range of interests and emotions tied up with the subject of foreign investment. We can use our long-standing experience as a source of international investment to say here are sound healthy international ground rules for international investment. We can now also use our new sensitivity to foreign investment to join with other countries in formulating legitimate expectations for foreign investors.

...You will see that the Code before you is not a tool to paralyse the transnational activities which we all know are so vital to the world economy. The Code not only works towards the concept of a "good corporate citizen", it also ensures fair and equitable standards of treatment of transnational corporations by host countries. In this respect, I am glad I have this opportunity to speak before you to try to dissipate the fear that the Code portends a stifling regulatory system in international business. This is a gross misconception by those who have not taken the time or trouble to read the text of the Code. Not only are the provisions establishing standards of behaviour crafted in language that is far from peremptory or mandatory, but in addition, these provisions are balanced by another set of provisions that guarantee essential protection to corporations, to enable them carry out their activities with minimum disturbance.

Arghyrios A. Fatouros *(continued)*

of effective dispute-settlement mechanisms and procedures, minimum consultations and discussions are possible. Where dispute-settlement mechanisms and procedures do exist, this clause would give an opportunity to conciliators or arbitrators to resolve problems not solely by reference to strict legal rules, but by considering the entire situation at issue.

National treatment

The definitions of national treatment found in international instruments and other authoritative texts are by and large similar, indeed often identical. A typical definition is that found in the treaties of friendship, commerce and navigation concluded by several developed countries. In a typical case, national treatment is said to mean:

> ...treatment accorded within the territories of a Party upon terms no less favourable than the treatment accorded therein, in like situations, to nationals, companies, products, vessels or other objects, as the case may be, of such Party.[7]

Essentially similar definitions, varying in their scope or their precise terminology, are found in such diverse instruments as the GATT (art. I), the Paris 1883 Convention on the Protection of Industrial Property (art. 2) and subsequent amendments, and the OECD Declaration of 21 June 1976 on International Investment and Multinational Enterprises.[8]

The national treatment standard usually operates within the territory of the country concerned, not at the border. This is the case, for instance, in the framework of GATT (as noted above), as well as in that of most bilateral treaties of friendship, commerce and navigation, to the extent they apply this standard. The principal exception to this generalization concerns economic integration arrangements, such as the European Community, where a rule of non-discrimination as against nationals may apply at the borders, as well as in the territory of each country member.

The typical formulation of the national treatment standard refers to "like situations" or to "like products". The exact content of this expression may be difficult to determine in concrete cases. The manner in which the products or situations are defined in the basic instrument involved is of particular importance. Determining in a specific case whether a domestic and a foreign-controlled enterprise were "in like situations" involves a judgement of particular facts. In the OECD practice, among the specific circumstances to be taken into account are the following: whether the two enterprises are in the same industry; the impact of policy objectives of the host country in particular fields; and the motivation behind the measure involved. In a number of recent texts, the word "similar" is favoured, although it is not clear in what exact manner "similar" differs from "like". References to "the same" or "identical" circumstances are rarely found in treaty practice, because the use of such words would tend to narrow down the meaning of the expression. There would be far fewer "identical" situations than "similar" or "like" ones.

Classical formulations of national treatment speak of treatment "no less favourable" than that accorded to nationals (or national products etc.). This formula allows two types of differentiation: first, it may cover treatment which is equivalent to that accorded to nationals, although not necessarily quite identical to it—as long as it is no less favourable; secondly, it may allow preferential treatment of aliens, that is, aliens may be accorded treatment better (more fa-

[7] Treaty of Friendship, Commerce and Navigation between the United States and Ireland, signed on 21 January 1950, art. XXI(1).

[8] OECD, *International Investment and Multinational Enterprises: The OECD Guidelines for International Enterprises* (Paris, 1986), pp. 9-10.

vourable) than that accorded to nationals. In response to this last possibility, there have been recent efforts, particularly by developing countries, to change the traditional formula by referring to "the same" treatment.

4. Most-favoured-nation treatment

The standard of most-favoured-nation (MFN) treatment is also a standard of non-discrimination, in this case between aliens and foreign-owned enterprises), of goods and services of differing national origins. The definitions in different treaties and other international instruments closely resemble one another.

The role of the non-discrimination standard is similar in the case of trade and in that of investment. This standard is relevant both with respect to treatment at the borders (that is, concerning the admission of products and investments in a country) and to treatment within the territory, while the national treatment standard is particularly relevant in the latter case.

In the early decades of its modern application, the MFN standard was formulated and applied conditionally, that is to say, the original "other contracting party" became entitled to the treatment granted to third States only if it were prepared to offer to the granting State the same concessions the third States had given. The MFN clause was thus applied on the basis of strict and specific reciprocity. More recently, however, the unconditional application of the MFN standard has prevailed. The treatment granted to a third State is now automatically extended to the State originally given most-favoured-nation treatment. Reciprocity is conceived in more general terms: a State grants MFN treatment to another in exchange for MFN treatment by the latter. The MFN standard thus becomes a method for extending non-discriminatory treatment on a more or less universal basis, using bilateral (or multilateral) agreements as a means for establishing uniform standards.

This aspect of MFN treatment was until recently thought to be well established. As the language of article I of GATT makes clear, the clause in its multilateral application is clearly and necessarily unconditional. Negotiations on trade in services have brought back the possibility of a requirement of specific reciprocity, that is, of conditional non-discrimination. Only those States which are prepared to accept certain commitments (for example, concerning national treatment of providers of services) might be entitled to corresponding treatment by other States. The logic of bilateral relations is thus imported into multilateral agreements (from which, it is true, it was never fully absent). Such a reversal in the direction of international economic and legal relationships has obvious costs, even apart from the resulting complications and uncertainties.

Participants at The Hague Symposium exchanged views with Code negotiators on how the interaction between international law/national law and the Code instruments could facilitate the formulation of the Code standards.

5. Conclusions

Provisions on standards of treatment in international instruments in effect acknowledge in legal terms that the treatment accorded foreign products, services and investments is an internationally relevant issue. It is, of course, a fundamental, long-established principle in international law that each State is sovereign within its territory and that its nationals as well as any non-nationals in that territory are subject to its jurisdiction. Recognition of international relevance does not imply any denial or limitation of territorial jurisdiction and sovereignty.

The national and most-favoured-nation standards are essentially non-discrimination standards. The rationale for the grant of such treatment varies depending on the industries and the subject matter involved. The assimilation of aliens and nationals forms part of the imperatives of the international protection of human rights, as far as basic standards of treatment of the person and property are concerned (that is, protection against arbitrary government action, guarantees of fundamental human rights etc.). This rationale may or may not extend beyond the treatment of the person to touch upon property rights and the rights of legal persons (companies and associations). From another angle, the grant of non-discriminatory treatment to foreign products and to the economic activities of aliens and foreign-owned firms serves to eliminate distortions in trade and competition and thus enhances the effective operation of the world economy. A more modern extension of this last argument points to the ongoing internationalization of investment and production and concludes that non-discrimination, in its various forms, is necessary for the effective functioning of increasingly internationalized enterprises and of an international economy whose principal trait is interdependence.

On the other hand, non-discrimination cannot be a global standard, to be applied without exceptions or qualifications. The basic political, economic and cultural unit in today's world remains the nation-State, which is responsible for national economic growth and welfare. There is no substitute for national action to ensure economic development, full employment, improvement of the quality of life etc. Co-operation among sovereign States does not necessarily depend on the total absence of differentiation between national and non-national activities and actors. Moreover, in a world marked by stark inequalities in economic power, technical capabilities and financial strength, differentiation between nationals and non-nationals may be necessary precisely in order to bring about a degree of operative equality.

In actual practice, with the partial exception of economic integration arrangements, the application of the general non-discrimination standards (both the national treatment and the most-favoured-nation treatment standards) is subject to extensive and far-reaching exceptions, derogations and other types of qualifications.

With respect to trade in services, additional problems arise. Since in many cases services cannot be inspected at the border, the national regulation of services plays a dual role, equivalent to both tariffs and marketing regulation in the case of trade in goods. Non-discrimination standards may, furthermore, not be the most appropriate, that is, the most effective standards with respect to services, since discrimination against foreign providers of services is not the only significant barrier to the increased flow of services across borders. Many service industries are subject to national regulatory régimes (as in the case of banking, the liberal professions, telecommunications, advertising etc.), and the differences between national laws are, even in the ab-

sence of discrimination, powerful barriers to international transactions in services. The recent experience of European Community countries is particularly pertinent in this respect.

The existence of such problems renders the "fair and equitable treatment" a broad and usefully flexible standard. This standard is better to be understood not as implying other standards or international legal principles, but as providing for the prudent and just application of legal rules to particular situations. In this sense, it does refer by implication to such principles as that of non-discrimination, but in a concrete manner. It is not discrimination as such that may be said to constitute treatment infringing on the fair and equitable standard, but undue discrimination, discrimination that in context is inappropriate and "unfair". This standard thus provides a convenient concept for starting discussions on any case of alleged mistreatment of an investor (or, in the case of trade in services, a services provider).

Development

1. Development as a basic principle

The economic and social development of developing countries is recognized today as a fundamental aim of the international legal and economic order. A major recent instrument in which such recognition is explicit and pervasive is the United Nations Convention on the Law of the Sea, signed at Montego Bay, Jamaica, in 1982.[9] Among its aims, "the realization of a just and equitable international economic order" is mentioned. This aim determines its structure and provisions. The formulation of its articles is shaped by concern for the interests as well as the capabilities of developing countries, while specific provisions are directed at providing resources to developing countries for their development, in the general interest of humankind. Another recent pertinent illustration is found in the Punta del Este Ministerial Declaration on negotiations on trade in services.[10] It is significant that development is not listed in it as a factor to be taken into consideration or as a possible ground for exception or special treatment, but constitutes one of the principal aims of the negotiations.

This fundamental aim is given effect in a number of ways. Sometimes, an entire instrument is intended to serve it; more often, recognition of its priority determines the provisions of instruments with a broader scope and purpose. The instrument is so structured as to address its provisions to the situation of developing countries, and to maximize its contribution to development. It involves the selection of issues on which commitments are to be made, the appropriate formulation of rights and obligations so as to take into consideration the capabilities and needs of developing countries and the choice of measures and sectors to be covered.

The structure and contents of the draft United Nations Code of Conduct on Transnational Corporations are pervasively determined by the principle of promotion of development. The Code establishes standards for the activities of transnational corporations in developed as well as developing countries, and for their treatment by such countries in their role as possible home and host countries. Thus the Code, while not dealing solely with the situation of developing countries, shows special concern for conditions therein and for their interests. It

[9] United Nations Convention on the Law of the sea, *The Law of the Sea* (United Nations publication, Sales No. E.83.V.5), p. 1.

[10] *General Agreement on Tariffs and Trade Focus* (8 October 1986), "The Punta del Este Ministerial Declaration", Part II, "Negotiations on trade in services".

Hearings on the Code:

Excerpts from the testimony of Sidney H. Willner

Sidney H. Willner

...The other issue or set of issues has proved more intractable. There is agreement that host countries should give fair and equitable treatment to transnationals and that there should be no discrimination. Underlying the seeming semantic dispute as to whether the host countries should be bound by "international law" or by their international obligations, similar to but more substantive than the long stand-off between "peaceful coexistence" and "friendly relations among nations", are, however, the issues as to what principles should govern the expropriation of the property of transnationals and the compensation for it, and what is the proper forum to determine their application.

These are indeed serious issues, although increasingly more so in the abstract than in real consequences. They involve, on the one hand, the emotionally charged conceptions of sovereignty, as well as acceptance of international rules of law in the formulation of which the developing countries had no role and, on the other hand, resistance by the developed countries to arbitrary actions, generally by successor Governments of host countries. Resolution of these problems will undoubtedly be on a step-by-step basis through a series of bilateral and multilateral agreements, already under way, which should, in the course of time, lead to a more widely accepted set of international rules. The question is whether or not the adoption of the Code should be held up until that process has been completed.

The attitude of the United States Government in the past appears to have been that since the Code is important to the developing countries and not to the developed countries, the developed countries should not agree to its adoption unless and until they get a *quid pro quo* in the form of concessions on the matters of concern to them. I believe that premise is wrong because we have a very real interest in the establishment of agreed principles of conduct wholly aside from the desire to help others, which we have always considered part of our ethos.

Many times in the course of my corporate career I have been confronted by urgent requests from our people in the field to bend our principles because our competitors did not abide by such principles and therefore had an important advantage. While we were able to resist those appeals and remain successful, that experience brought forcibly home to me the value of having a commonly accepted set of principles of conduct consistent with what we have developed in our own country and that we regard as necessary for the protection of our people and our institutions. This has become increasingly important with the proliferation of transnational enterprises, including those of countries that have not developed the same standards of conduct.

Adoption of the Code will of course not eliminate the possibility of abuse, but should represent a significant advance. The only reason I can perceive for not adopting the agreed substantive provisions is that, by holding out even longer, we will achieve agreement on the separate and distinct issues mentioned above. I believe that the past history indicates that this is illusory, and that we should proceed to do what can be done now.

seeks to ensure that not only Governments, but transnational corporations as well, will work for the promotion of development.

Such an approach implies an effort to adapt the relationships in an international instrument to the particular conditions and needs of developing countries. The case of international double-taxation conventions provides a useful illustration. Such conventions have devised methods for avoiding double taxation by allocating categories of income between the taxpayer's country of residence and the country in which the income originated ("country of source"). As the OECD Fiscal Committee pointed out in a seminal report,

> "existing treaties between industrialized countries sometimes require the country of residence to give up revenue. Such a pattern may not be equally appropriate in treaties between developing and industrialized countries because income flows are largely from developing to industrialized countries and the revenue sacrifice would be one-sided".[11]

To remedy this kind of imbalance, changes in the contents of those treaties were found to be necessary. The definition of "permanent establishment" was amended, so that it includes additional types of operations. Similarly, the allocation of tax jurisdiction for income from shipping was changed to allow developing States additional revenues.

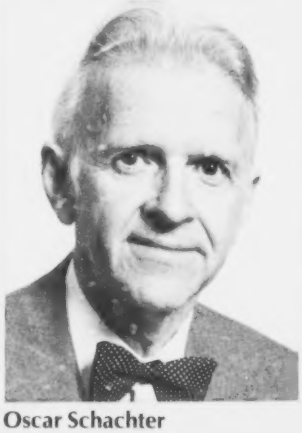
2. Preferential treatment of developing countries

An equally significant manifestation of the principle of the promotion of development is the application to developing countries of special rules and principles, so as to assist them in their pursuit of development. Developing countries may be exempted from some or all of the obligations undertaken in an agreement, may be given longer transitional periods or may be allowed to invoke their status as developing countries or their need to promote their development in order to avoid carrying out particular commitments.

[11] OECD, *Fiscal Incentives for Private Investment in Developing Countries: Report of the OECD Fiscal Committee* (Paris, 1965), para. 164.

Hearings on the Code:

Excerpts from the statement by Oscar Schachter



Oscar Schachter

Your inquiry is especially timely. After more than 12 years of work by the United Nations Commission on Transnational Corporations, a draft has emerged that for the most part has been accepted by all the members of the Commission, representing the different groups of States. That is a considerable accomplishment. Nearly all the articles that relate to the conduct and obligations of transnational companies have been agreed. Agreement has not been reached on some of the articles that concern the obligations and rights of States *vis-à-vis* transnational compromise. However, compromise proposals have been put forward that meet many of the problems raised. In my opinion, the differences that have arisen on these unsettled points are amenable to reasonable solutions that would not involve abandoning basic positions of the Governments.

The interest of the United States in the Code of Conduct

It is important that the Congress and the Executive Branch recognize why a code of conduct on the lines of the present draft would serve the national interest of the United States. The fact that a code has also been favoured by the developing countries and by the "socialist" countries does not mean that the United States and other developed countries would not gain by the Code. All States have a positive interest in ensuring that transnational corporations (TNCs) meet generally accepted standards of behaviour and that they are fairly treated by Governments. The United States interest can be summarized under three headings:

1. The United States as the "home" country of TNCs

The United States cannot be indifferent to the conduct of United States companies operating abroad. Improper and offensive behaviour involves political costs to the United Staes. It may also reduce opportunities for future business by American companies and impede foreign investment. The anomaly of United States companies engaging in illicit payments, tax evasion and restrictive practices in foreign countries when such conduct is forbidden domestically should not be taken lightly by the United States Congress or the United States public.

2. The interest of the United States in expanding trade and development

Transnational corporations play a major role in organizing and carrying out trade, investment and transfer of technology across national lines. They are especially important to the United States in the growing areas of information-based technology and services. Agreed international guidelines for their conduct can help substantially to reduce conflict and hostility in host countries. In addition, common standards for the treatment of TNCs by Governments can reduce uncertainties that would impede the trade and investment by TNCs desired by virtually all countries.

3. The interest of the United States as a host State

The United States is the largest host State of transnational companies. The increase of foreign investment in the United States has vastly increased foreign corporate holdings of property and business enterprises. It is a mistake to assess the Code of Conduct as if it concerned only the developing countries as hosts. We must remember that United States law and policy require foreign property owners and business to submit to legislative and judicial jurisdiction of the Federal and State Governments. Sovereign rights of expropriation and eminent domain are exercised under constitutional requirements of "just compensation" that are not precisely the same as rules urged by the United States Government against foreign expropirating States. "National treatment" of foreign companies is subject to significant exceptions in the United States. Whether or not such policies and laws are desirable may be debated, but they clearly fall within the sovereign authority of the United States. Obviously an international code cannot make exceptions for the United States or impose more restrictive rules for developing or centrally-planned economy countries. Moreover, it would be myopic for the United States to consider only the role of United States companies in developing States and to ignore the interests of the United States in applying its law to the foreign companies within the country.

In the draft United Nations Code of Conduct on Transnational Corporations, the proposed paragraph on national treatment includes an exception allowing a developing country additional leeway in its measures and policies towards TNCs. A more far-reaching provision is found in the framework of GATT, where the principle of preferential treatment for developing countries and of non-reciprocity in concessions was first declared in part IV of the Agreement, adopted in 1964, and later formally adopted and elaborated at the Tokyo Round.

A number of international instruments are directed at the promotion of development in such a perspective. An important example in an interregional context, remarkable for its comprehensive character, is the 1984 Convention between 66 African, Caribbean and Pacific States and the European Community, better known as Lomé III. In providing for co-operation between the two groups of States, with a view to promoting and expediting "the economic, cultural and social development of the ACP States", the Convention covers several areas, including agriculture, industrial development, mining, transport, trade and culture. Both financial and technical co-operation are used as instruments of the Convention.

3. Conclusions

The overriding principle of the promotion of the economic development of developing countries finds expression today in most major international framework agreements. It is therefore relevant to all negotiations, including those on services. The principle is given effect in the very structure and in the aim and purpose of international instruments, in terms of their being designed to fit the conditions and needs of developing countries and of contributing to development. It is also given effect as the foundation of other arrangements and substantive provisions addressing development objectives in the sense of ensuring preferential treatment for developing countries, allowing exceptions on the basis of their less developed status etc.

In the context of the negotiations on services, the possible conditional application of the principle of non-discrimination (or a concomitant insistence on specific reciprocity in commitments) would involve a serious departure from basic GATT principles and create special problems for developing countries. Full and consistent application of the principle of preferential treatment would presumably require that developing countries be allowed to take advantage of commitments undertaken by developed countries (for example, with respect to the grant of access to markets, establishment or national treatment), without being required to make equivalent commitments. Application of this principle may be formally evaded through conclusion of separate instruments, to which only States willing to commit themselves on such issues would be parties, or through other methods, but the substantive infringement of a fundamental principle would not thereby be avoided.

Concluding observations

This survey of key concepts from international framework agreements concerning foreign direct investment shows that the experience accumulated in such agreements and reflected by those concepts may be of immediate usefulness in the negotiations on trade in services. What is involved is something more than the mere availability of a stock of notions, principles and approaches. However comprehensive it may turn out to be, an eventual instrument covering trade in services will be greatly helped by the recognition that it stands against the background of other instruments in related or overlapping fields, namely, several instruments in the GATT framework as well as multilateral, regional and bilateral instruments relating to investment. Among the latter, pride of place should be acknowledged to the draft United Nations Code of Conduct on Transnational Corporations. It is true that the Code has not yet been formally adopted and some disagreement persists with respect to some of its provisions. Yet, the Code is remarkable for its structure, the number of its provisions that have found consensus among all groups of countries, its comprehensiveness and its practical concern with concrete problems of operations rather than abstract issues of law. Its approach and its provisions may be understood as usefully complementing any eventual framework agreement on trade in services.

The Code covers most significant issues concerning foreign direct investment. Not only its concepts and classifications, but the approaches it suggests for resolving problems and conflicts should prove useful to any framework agreement in related areas.

Moreover, the Code of Conduct deals at length and in detail with, indeed focuses its whole approach on, a principal actor in the present-day world economy, the transnational corporation. Its role not only in foreign direct investment in general, but also particularly in the provision of services, has been abundantly documented. An international framework agreement which limits itself to the intergovernmental level leaves by necessity out of consideration a series of important and difficult issues, namely, those concerning the entities which engage in activities the legal regulation of which is the instrument's principal object. In providing for limits and types of national measures, allowed, encouraged or discouraged, such an instrument indirectly deals with the conduct of enterprises: what they may do, what they may not do and in what ways their actions may be influenced. Yet, the actual conduct of the enterprises is not directly touched upon.

The existence of a parallel instrument whose main thrust concerns the activities of TNCs provides a useful complement. Those enterprises are no mere objects in the international economy, nor are they weak, impotent observers of the action of States. Their conduct is determined not only by the margin of freedom allowed by government measures or by the encouraging or discouraging action of Governments, but by their own structures, policies and approaches. The draft United Nations Code of Conduct on Transnational Corporations directly addresses these issues. It provides guidance to enterprises with respect to appropriate policies and activities; it points at ways in which their beneficial impact on the economy and the development of host countries can be enhanced; it stresses the areas and methods of possible co-operation with Governments; and it indicates ways for avoiding conflict. It acknowledges the central role of TNCs in the pursuit of international development and seeks to enhance its effects. Provisions on the structure and responsibility of enterprises, such as those summarized earlier, attempt to cope with major facets of business operations in today's internationalized economy. The Code of Conduct thus covers a significant dimension of present-day international economic relations, which would otherwise be effectively disregarded. It provides balance to existing or future framework agreements moving solely at the level of intergovernmental relations and dealing exclusively with the rights and duties of Governments. □

Corporations, conduct and codes: investment and trade in the Uruguay Round

By ***Seymour J. Rubin***

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Introduction

As of 1990, progress towards a universally acceptable code of conduct, one of the main objectives of the United Nations Commission on Transnational Corporations, seemed—at least to an outside observer—to have ground to a halt. From the second session of the Commission, held in Lima in 1977, agreement on such a code had been one of the principal objectives of the Commission, and became one of the principal occupations of both the Commission and the Centre. The goal could be argued to be within reach, at least on the statistical basis of articles on which there is either agreement or no substantive dispute. Only a few points were still in dispute, and efforts had been made to resolve even those in a mutually acceptable manner. Moreover, some of those issues, such as "jurisdiction", were matters on which disagreement had existed for a very long time at the expense of some discomfort in international relations, but no real threat to the international community.

The reality, however, suggests otherwise. In the first place, from the inception (starting with the Report of the Group of the Eminent Persons[1]), sceptics have suggested that a broad agreement in principle on investment and conduct of the sort envisaged was bound to founder. Citation for this proposition included reference to the sad fate of the International Trade Organization (1948), which died a-borning in the United States Senate, largely because of dissatisfaction on the part of United States industry with the protection—or lack of protection—which it found (or thought it found) in the two articles of that multi-purpose Charter which dealt with investment.

The clauses of the United Nations draft Code on which disagreement continues are in the same area, and involve opposing but firmly held conceptions. On the one hand, the developed nations feel that insufficient protection from the actions of Governments of host countries is given to TNCs and to their investments abroad—and too little understanding shown of the necessities of conducting efficiently a world-wide business enterprise. On the other hand, the developing nations feel that too little recognition is given of their right to make TNCs accountable under domestic law. A third disturbing factor was the insistence of several of the socialist delegations that the entire Code exercise arose out of the transgressions of TNCs and its clauses should reflect that asserted fact.

Those points of view, held with the fervour of religious tenets, negated some of the optimism, based on an arithmetical count of articles agreed and those remaining unagreed, as to early conclusion of a broadly acceptable and general Code. Attainment of such a Code almost seemed like a mirage, often apparently within grasp, but always fading into the distance.

Alternative formulations were considered, formally or, more often, informally. Those included the suggestion that a code might state only broad principles, in terms sufficiently general as to be acceptable to all, with specifics being worked out over time through implementation at the national level and periodic review by the Commission. Unsatisfactory as this exercise in "constructive ambiguity" might seem to be at first glance, such an evolutionary approach would not be unique in either domestic or international rule-making. For example, the antitrust law of the United States is based on formulations and concepts which are simply stated (as are the antitrust prescriptions of the European Community), but which are elaborated either by legislative or judicial expansion.

That concept of a Code which might consist merely of a broad and gradual development of rules accompanied by commitments to frequent consultation and to further elaboration—never put forward as a formal proposition by reason of its certain failure—had a certain amount of recognition in the concept of a "zebra" code—one in which certain principles would be stated in terms of "shall" and others in terms of "should". That idea, though openly discussed, also attracted little support and perished for want of nourishment. Successive attempts to find formulations satisfactory to the major players—the developed market economies, the developing nations (including in that category nations as widely divergent in their stages of development as Chad and Mexico), and the Socialist nations of Eastern Europe—also foundered. By the mid-1980s, some ten years after the Lima formulation of priorities and the 1982 Mexico City valiant attempt to achieve agreement, it was a barely disguised consensus that a Code was probably a distant dream—and, by now, of little real interest, at least to the developed countries.

The developed nations had never been enthusiastic, at least about this type of Code, which spoke more in terms of the obligations of TNCs than in terms of their right to fair treatment and protection of their property; they clearly preferred the work done in OECD. The developing nations felt that, in the effort to bring developed nations into agreement, too many concessions already had been made to TNCs, and that the effect of the Code might be more to restrain Governments of host countries than to restrain or correct the behaviour of TNCs. The Eastern European group was wary of the persistent insistence by the Western group

[1] See *Report of the Group of Eminent Persons Entrusted with Studying the Effects of Multinational Corporations on Development and Economic Relations* (United Nations publication, Sales No. E.74.II.A.5).

that business entities based in Socialist countries were also TNCs. And a spirit of weariness, of words which were too many and too often used or misused, seemed to permeate the annual meetings.

Against this background, the thesis of the present article—that in fact the United Nations Code is a useful document—may seem strange. Clearly, given the difficulties and preoccupations on all sides and the sense of ennui which has characterized many of the recent sessions of the Commission, the burden is on the exponent of this thesis to justify it. But that can be done. A Code—as near universally acceptable as is possible—would be an important and helpful document in itself, responding to the yearnings of developed nations for a "GATT for Investment", and it would provide a valuable mine of clauses which could fit neatly into the increasingly service- and investment-oriented Uruguay Round. In that respect, it could be responsive to the same type of considerations which lay behind many of the provisions of the United States-Canadian Free Trade Agreement.

The remainder of the present article attempts so make such a case—that a United Nations Code is attainable, that it would be useful in itself at this stage in world economic history and that it would contribute to the success of the Uruguay Round. Since the present author comes to this conclusion after participation in years of difficult negotiations and sometimes contentious discussions, he has not reached that conclusion lightly. But he is persuaded that the utility and the feasibility of a Code require that the effort be pursued.

Some background

Interrelationships

Briefly stated, the conclusion that the Code has value and should be pursued, by developed and developing nations alike, is based on the fact that options in the world of international trade and international investment have become even more intertwined than was the case only a few years ago; that the trade-and-debt problems of the developed and developing world are bound up with investment and investment policy, and therefore with TNC activity; and that many of the "concluded provisions" of the proposed Code are markedly relevant to trade issues, especially in that area in which many nations hope to achieve progress, in the face of hitherto more or less unchallenged obstacles, that is, trade in services.

Given the proliferation of TNCs and their importance, not only to international investment, but also to trade, this is hardly surprising, though it has been largely unnoticed. There seem to exist two different universes of discourse: that of trade and finance, and that of the body which deals with the entities through which much trade and more finance is conducted—TNCs. The convergence of focus on trade issues in the Uruguay Round, and on debt and development (of, for example, the Brady initiative) compel a re-examination of the Code efforts.

The provisions of the Code on corporate/state conduct and on TNCs could, in many instances, be replicated in Uruguay Round conclusions. in that sense, the old concept of a "GATT for Investment"—which, when proposed, seemed impractical to many observers mainly because fundamental principles had not been worked out or even openly debated— has now acquired a new vitality. This lends importance to ongoing discussions on the Code and on the substance of its provisions, both in the context of the Commission and in the debates centred on the Uruguay Round. It is hard to think of trade debates these days without focusing to a major extent on "trade-related investment measures" (TRIMS), or on the many aspects of trade in services and intellectual property protection, which importantly link investment and trade.

This is most strikingly illustrated when one considers that the "right of establishment" is a dominant topic in service-trade agreements, and that that right is fundamental for investment understandings. And this is so, whether the discussion takes place in the United Nations Commission on Transnational Corporations, in the Uruguay Round or, indeed, in the context of many of the debt-crisis proposals which now abound. In no way is this connection more evident than in debt-equity swaps, where a debt incurred in trade is converted into a transborder investment. (Parenthetically, it may be noted that debt-equity swaps, if extensively used—which would almost necessarily imply few restrictions on the type of equity acquired—would take much of the force out of restrictions of right of entry.)

Some background on why there have been continuing efforts to produce a "GATT for Investment" and why, until now, they have failed, is expedient.

The nature of the corporation

That privately owned corporations are entities which formulate or heavily influence the formation of public policy has been a cliché since the seminal work of Berle and Means in 1933, if not before.[2] In varying subspecies, depending on national terminology and habit of mind, corporations have proved to be the most effective way of organizing large-scale economic activity. The essence of the "corporation"—whether it be a "limited partnership" or another variant—is that it can provide opportunity for boundless profit with limited down-side risk. It thus brings together capital more easily than would be the case were the individual investor to risk all; it provides unified management; and it can more or less guarantee continuity as it is a juridical and not a "real" person. Those advantages have brought the corporation, in its various manifestations, as a means of combining capital and limiting risk, from a *modus operandi* for individual ventures to a means of operating over extremes of space and time, and, especially in the common-law world, from its early post-medieval position of being highly suspect and of being required to obtain its birth certificate in the form of a special act of the sovereign (which contained stringent limitations and requirements for its continued existence) to the present position of being, in one or another form, the universally recognized method of doing large-scale business.

The three basic attributes of the corporation—limited liability for its owners, centralized management and continuity—have made it an institution able to make a major contribution to the economic growth of the modern world. They have also been essential to, and a reason for, the enormous concentration of wealth—and power—in the modern corporation. Though most if not all such corporations are private in the sense that their shareholders are individuals (or other corporate entities) and not Governments, it has been evident from the outset that what corporations—at least large corporations—did was often essentially to exercise powers of governance in the society in which they operated. Certainly, they held their powers by grant from and at sufference of Government. The earliest of the English Crown-chartered companies—the Andalusia Company and the Prussia Company—were formed to receive Crown monopolies—a fairly evident grant of governmental power. Similarly, the British East India Company had evident and explicit governmental powers—and was eventually merged into Government.

Had the view continued that corporations were so closely associated with governance that each would require a special legislative grant of authority, the modern corporation would not exist. The utility of the corporate form was such in an expanding world of trade and commerce that modern and permissive incorporation laws became the norm. And, of course, as incorporation requirements were relaxed in the early years of the nineteenth century, not only did corporations increase enormously in number, but also, and similarly, in power and influence. But their provenance as entities created by and carrying special powers of the State does something to explain present attitudes and scepticism as to whether they are not, in the last resort, instruments of the State in which they are incorporated or in which they have their principal attachments.

For much the same reasons, in response to both needs and opportunities, the inter-

[2] Berle and Means, *The Modern Corporation and Private Property* (New York, Columbia University Press, 1933).

Hearings on the Code:

Excerpts from the testimony of John M. Kline

John M. Kline

...The major obstacle to completion of the Code is an absence of sufficient current interest and political will to resolve remaining disagreements on a few issues. A deadlocked debate based on old conflicts has so divorced Code negotiations from operational reality that government and business leaders have turned their attention elsewhere. A recognition of changed conditions is essential to re-establish political momentum, shifting perspectives from the past to the present by demonstrating to Governments their self-interest motivation in completing the final negotiating steps.

The United States Government should reassess its policy on the Code in light of its increased role as a host country to foreign TNCs, the growth of low-equity investments and TNC alliances, and the emergence of global issues that require an inclusive international solution. Those factors suggest formulation of a policy that supports and promotes the adoption of the United Nations Code of Conduct that will endorse areas of commonly agreed principles and facilitate follow-up action on specific issues.

The United States delegation should press actively at the next meeting of the Commission on Transnational Corporations for a resolution of remaining issues in the draft Code along the lines of the formulations suggested by the Group of Expert Advisers. The priority objective should be adoption of a Code containing agreed principles and guidelines on government and business responsibilities, laying the basis for enhanced co-operation on emerging issues of global concern.

...As we prepare to enter the 1990s, it is especially appropriate to look forward rather than backward. New challenges are arising in the international system that are truly global in their nature and impact. An unprecedented degree of co-operation and co-ordination will be required among nations, and with private business enterprises, to meet those challenges effectively. The United Nations Code could provide an effective international framework to guide that co-operation, facilitating the conduct of transnational business in a manner that is both responsible and responsive to the world's growing needs.

...The early 1970s were indeed a time of confrontation and controversy. Many developing countries had just emerged from the bonds of colonialism and demanded a new international economic order to recognize their sovereignty and speed their economic development. Industrialized nations, on the other hand, struggled to cope with the collapse of the Bretton Woods monetary system, the rise of the OPEC oil cartel and the early weakening of United States economic power.

Multinational corporations were caught in the midst of those changes. Still largely headquartered in the United States, these firms owned and operated subsidiary units located around the world. Several widely publicized instances of MNC misconduct, namely, revelations of overseas bribery of government officials and the ITT incident in Chile, led directly to multilateral negotiations on a business code of conduct. Debate on international codes thus began under a cloud of MNC criticism that was directed at controlling individual company abuses.

The United Nations Code discussions are still haunted by ghosts from those conflicts. Negotiators continue to debate such issues as political non-interference and expropriation/compensation standards that have lost most of their practical relevance in the contemporary world. Expropriations of MNC investments, for example, turned out to be largely a phenomenon of the early 1970s. Risk offset and insurance techniques have reduced corporate exposure, while governmental policy changes reflect a recognition that a stable business climate is essential to attract needed foreign investment. Many government officials and business representatives, however, remain locked in battle on this and similar issues in the Code negotiations. We need to step aside from such controversies long enough to reassess whether positions based on past fears and conflicts really correspond to current needs and realities.

...In order to generate a more activist policy on the part of the United States Government towards seeking a concluded United Nations Code, a change in perceptions must take place and a motivation to act in the national interest must be established. Perceptual changes stem from a recognition of the increased importance of transnational corporations in the global economy and the evolution that is occurring in the fundamental nature of those

Seymour J. Rubin *(continued)*

national aspect of the modern corporation developed. The broadening of the market, through better communications and transport, led inevitably to the interrelation of the several segments of the market. Just as the early "transnational corporations", such as the Hudson Bay Company, were formed to bring resources from one region to another, and to trade goods in exchange or payment, so business entities spread across national boundaries, efficiency being the motivating force.

The intermingling of trade and investment was an inevitable consequence. It was also a consequence that produced both opportunity and risk. The unsophisticated trading post of the eighteenth century became the subsidiary corporation of the twentieth century, the importance of which was often such as to overshadow that of the parent. In trading goods from one country to another, it was not merely the usual terms of trade that governed, but the relations of subsidiary to parent, and of subsidiary to subsidiary. Intra-company trade became an important statistic in international trade. The national loyalty of such enterprises was in doubt, a doubt reinforced when production was halted or curtailed in one country in order to focus it in another, for whatever reason.

The birth of the Code movement

More or less at the same time, concern arose among host countries, mainly but not entirely in developing countries, that the interests of transnational corporations and those of the countries in which they operated were not entirely coincident. Noting and contrasting the evident prosperity of the transnational entities, and their own disappointing poverty, sentiments of nationalism became an integral aspect of developing-nation positions in international conferences and, more importantly, in their own national policy. Hence arose a call for "codes of conduct", perhaps best symbolized and summarized in the Abs-Shawcross drafts of the early 1960s, and in the OECD draft Convention for the Protection of Private Foreign Investment, promul-

enterprises. One impact of these developments on the United States is the new role the country will play as the world's largest host nation to foreign enterprises, while it still remains the single largest home country as well. Paradoxically, the nation is now less able unilaterally to determine or to control the full impact of those transnational corporation activities, which are increasingly diversified in their organization, operations and the national identity of their products and processes.

Within these changed circumstances, a primary motivation for United States action on the Code will come from a look at the emerging agenda of global issues. The resolution of many of these issues will require broad international co-operation among both nations and TNCs. In an integrated world trading system, an inclusive international business framework is essential if we are to meet effectively such global challenges as environmental protection, worker and product safety, the establishment of transnational banking and securities networks, and the achievement of renewed and sustainable growth, particularly in the developing countries.

...An agenda of emerging global issues may also bring a new perspective on the role and function of the United Nations Code. Many of the new problem areas are truly transnational in their impact and the manner in which they must be managed. United States' interests in these issues should provide a motivation for action to complete a United Nations framework agreement on transnational corporations that can encourage and guide the relationships between international public- and private-sector parties as they struggle with these problems.

Protection of the environment is an obvious example, since pollution of the air or oceans is not territorially restricted and can quickly spread beyond political boundaries.

...Other international challenges are emerging rapidly in the co-ordination of product-related health, safety, and quality standards. For example, in an integrated world trading system, it is difficult to detect or control unilaterally the incorporation of sub-standard or counterfeit goods in manufactured products, or residue pesticide levels in agricultural produce. The safety and reliability interests of consumers everywhere, including in the United States, argue for improved co-ordination among the widely varying national criteria, regulations and enforcement procedures in such matters.

A supportive framework agreement on transnational business activity is equally necessary for the continued development of global stock markets and securities exchanges, or linked data-processing services and media-transmission facilities.

...I do not mean to imply that the United Nations Commission on Transnational Corporations should be the primary forum for dealing with all of these issues or that the various items must be specifically addressed in the Code's provisions. Obviously the Code is not designed for such a task. The broad principles and guidelines established in the Code can lay the foundation for further progress, however, by solidifying the common ground that exists on many fundamental transnational business principles. Even if a few items must ultimately be left aside in the interests of concluding a final agreement, a successful conclusion to the Code negotiations would serve to recognize and certify the many areas in which progress has been achieved, as well as set the stage for improved follow-up co-operation on applied problem areas in appropriate international forums.

Negotiations on the Code are at a critical juncture. Unless positive action is taken soon, the lost political momentum may leave these discussions floundering too far behind changing international conditions. Worthwhile achievements are possible, and a window of opportunity exists for forward movement, but only if the parties can break free of old debates and focus on addressing the agenda of the future.

As was suggested earlier, most of the obstacles remaining in the path of a concluded Code are primarily contentious owing to their past history rather than their current relevance. While originally associated with criticism of TNCs, the Code negotiations are actually based on balanced and positive objectives that seek to maximize the benefits of transnational business while minimizing potential conflict situations and negative impacts. The growing significance of TNCs in the global economy increases the importance of concluding an international accord that can promote and guide their activities.

...Recently changed political circumstances make progress possible on such an agreement. Governments of most developing countries recognize TNC benefits and actively seek to attract foreign investments into their economies. Movement continues on a number of co-operative, issue-specific agreements, many in United Nations organizations, that address a range of international business issues. The United States Government is now more open to United Nations institutional activities and, with the advent of a new Administration, a timely opportunity arises to reassess United States policy and priorities regarding negotiations on the Code.

We can remain chained to the ghosts of the past, or we can define a vision of the future through a more activist commitment to the United Nations Code process. The successful conclusion of negotiations on the Code is in the United States national interest as well as in the interest of the world community as a whole. The United States Government should be a leader in the attainment of that goal.

Seymour J. Rubin *(continued)*

gated in 1967.

As is evident, and need not be elaborated here, the creation of the United Nations Commission on Transnational Corporations, and of the Centre, arose out of the concerns of the developing countries rather than of the investing corporations. The Code envisaged by the Commission was originally proposed as a set of standards of conduct—both negative (that is, prohibition of harmful acts, or of acts thought to be harmful) and affirmative (that is, obligations to "do good", to contribute to a positive balance of payments, to higher standards of environmental, conduct etc.).

Neither the aspirations of the 1967 OECD draft Convention nor of the United Nations Code, as originally proposed, were either realistic or viable. The 1967 OECD draft was a document acceptable to Governments of host countries only were there to be uncritical and complete acceptance of the dogma that foreign private investment was always beneficial. It made only the slightest of glancing concessions to criteria for the conduct of such investment, and it lavished such protection on foreign investment that even officials of the Government of the United States (conscious of the many intrusions of that Government on private interests over the years) were unable to accept it. On the other side, the proposals put forward in the early days of the Commission on Transnational Corporations were characterized by the reiterated claim that the purpose of a Code was to redress the damage to the interests of the developing nations done by transnational corporations, to restrain them and to prevent their inflicting further and worse damage on the poor and the less developed. Such a Code was to contain no admonitions addressed to Governments, certainly not to Governments of developing countries, though standards of generosity were in several ways urged on the developed nations.

Reality has, however, imposed on all parties recognition of mutuality of benefit in a

reasonable set of standards. The debt crisis has underscored the possible disadvantages of protecting "permanent sovereignty" over natural resources by borrowing from foreign lenders rather than allowing—or even encouraging—foreign direct investment. The importance to favourable trade balances—or reduction of trade deficits—has underscored the importance to developed nations of the markets of the developing countries and the consequent desirability of economic practices that promise development. The expansion of industry in developing nations and the development of third-world-based TNCs has emphasized their interest in reasonable standards of protection. Alleviation of debt obligations through debt-equity swaps has been seen on all sides as a favourable methodology. Bilateral investment treaties, which celebrate the mutuality of advantage in direct investment, have proliferated. The World Bank's Multilateral Investment Guaranty Agency (MIGA), which is based on that mutuality of interest, is agreed and operating, after many years in which a similar though not identical concept languished.

In some respects, there has been what might be called a role-reversal. For whatever reason—the debt-crisis, the evident need for resource-directed capital or another—developing nations are manifesting their interest in attracting the foreign investor by relaxing, rather than increasing, restrictive measures. Meanwhile, major investing (or capital-exporting) nations, such as the United States, have nervously commissioned studies—and even introduced draft legislation—based on worries that their sovereignty or national welfare—if not security—may be impaired by the foreign investor and that investment abroad may lead to disinvestment at home. Interests of different groups of nations, once seen as widely divergent if not opposed, seem to have converged, at times to have overlapped. The hard edges seem to have softened. *Perestroika* and *glasnost* are widespread.

In this *ambiance*, the negotiation of the United Nations Code is far from the unlikely event which it once seemed. The previous rancour seems to have gone out of the discourse, leaving open the possibility—if not the likelihood—of agreement on principles which will facilitate useful foreign investment. In that regard, the proliferation of bilateral investment treaties and the acceptance of variously worded but uniformly investor-oriented clauses may lead developing nations to calculate that they may do better with standards negotiated in a multilateral than in a bilateral forum, and reinvigorate their interest in the Code.

The Uruguay Round

It seems likely that the code may be successfully negotiated, despite previous difficulties. One reason for such a possibility is that many of the issues involved in the Uruguay Round of Multinational Trade Negotiations have, in fact, been for years under negotiation in the Code exercise, and that some degree of consensus has been reached on them. The interweaving of trade and investment questions has been such, and so substantially demonstrated over the course of the past years, that many of the features of a "level playing field" are, in fact, dealt with in the Code negotiations. The Montreal Ministerial Declaration, for example, calls for "further identification of the trade restrictive and distorting effects of investment measures that are or may be covered by existing GATT Articles" and other "investment measures that may not be covered adequately in existing GATT Articles, but are relevant to the mandate of the Group given by the Punta del Este Ministerial Declaration"; the Group is also directed to consider "development aspects that would require consideration".[3]

Given the work of the United Nations Commission on Transnational Corporations, it would seem that those mandates could be advanced by consideration of the rather substantial achievements on investment measures which are contained in the current draft of the Code. It may well be that the language of the articles so far more or less agreed in the Code should—and undoubtedly will—be modified. But their relevance, and the relevance of the work done in achieving a rather substantial amount of consensus, to Uruguay Round objectives is clear. Clauses having to do with national treatment, and with a balance between the interests of developing countries and of developed nations in investment matters, are surely fundamental to fair trade practice, especially in the day of present and growing internationalization of investment, and of international investment as integral to world trade.

The United Nations Code, even in its present incomplete form, is partially useful to mutually understood and agreed provisions regulating trade where, as in services, "right of establishment" is important. The Code has the flavour of the environment in which it has been negotiated—that is, it reflects something of the concern of developing nations about unrestricted entry of foreign investment. The right to determine which investment may enter a nation has traditionally been cherished as an inherent right of sovereignty. (This does not, of course, prevent that right from being bargained away to a greater or lesser extent—the right to make such a bargain being also an inherent aspect of sovereignty.) In the past, developing countries have worried greatly about control of their economies through foreign investment. That fear has to a substantial extent been responsible for their preference for financing investment through debt leading to the present debt burden. But it is not confined to developing nations alone—as evidenced by the present worries in the United States about "the sale of America" to Japanese or other foreign interests. It is likely that, whether or not explicitly acknowledged in an understanding on trade in services, some aspects of the flavour of the United Nations Code regarding right of entry will be reflected, whether by the listing of restricted industries, percentages of foreign investment, reporting requirements or otherwise. What does seem clear is the relevance of discussion and possibly of clauses themselves, in the United Nations context, to Uruguay Round negotiations.

As was pointed out in *The New York Times*, "In the great race for overseas sales, many...companies are rushing to manufacture abroad..." Trade requires that "you have to be inside foreign markets...."[4] The link between trade and investment works in both directions. Standards developed in a "Code" dealing with foreign investment (and its treatment and its practices) are a vital part of the world trade rules which continue to evolve in the Uruguay Round.

Trade in services and the Code

The Uruguay Round of trade negotiations should thus produce renewed interest in the United Nations Code, as well as in other efforts towards standards of conduct for, and treatment of, the foreign affiliates of TNCs. Code efforts have a considerable relevance, especially in the area (of great prominence in the Uruguay Round) of trade in services. Much foreign trade leads to foreign investment, in the natural evolution from "mere" trade to establishment of operations in the country of destination of goods which are essential for the promotion of sales or servicing of such goods. Where services are the "commodities" being traded, it is almost always necessary to have some sort of establishment (or investment) in the country in which such services are consumed, it being the nature of services that they are produced and consumed in the country of destination. Since the topic here is "trade in services", there is a tendency to emphasize the transborder aspects. But in most cases, in large industries, trade in services involves a foreign investment aspect. It also may involve immigration issues, as is illustrated in the Canadian-United States Free Trade Agreement.

Where obstacles to trade in services exist, they generally take the form of regulation within the country of destination—not, as is more often the case with goods, at the border. In respect of trade in goods, most-

[3] See "Report of the Montreal Meeting of the Trade Negotiations Committee, News of the Uruguay Round of Multilateral Trade Negotiations", NUR 027, 24 April 1989 (GATT, Geneva, 1988). MTN.TNC/11, para. 1.

[4] Louis Uchitelle, "Spread of U.S. plants abroad is slowing exports", *The New York Times* (26 March 1989), p. 1.

favoured-nation treatment is the fundamental principle, with national treatment being important, but in many respects secondary. The situation is different in respect of trade in services. In that situation, regulation is both internal and directed towards the supplier of the services. Regulations are directed towards branch banks, insurance companies, travel agencies or the like—that is, towards entities established in the country of destination. Thus, the national treatment provisions of the several "investment" codes, whether they be the United Nations Code, the OECD Declaration, guidelines or even the bilateral agreements, such as bilateral investment treaties, become central to an understanding, within the Uruguay Round, on trade in services.

The OECD Declaration, for example, provides that member countries should, consistent with their needs to "protect their essential security interests and to fulfil commitments", accord national treatment to "foreign-controlled enterprises".[5] The report of the Secretary-General on the work on the Code, after stating the obvious right to control entry, goes on to provide "fair and equitable treatment". This (despite the problem of defining exactly what constitutes such treatment) is an absolute standard and, from the point of view of the trader-investor, a considerable advance on the purely comparative standard of national treatment (or, for that matter, most-favoured-nation treatment). In other words, even if the State in question acts unfairly towards its own investors, the provision requires fair treatment for the foreign investor. The United Nations draft Code goes on to adopt also the national treatment standard: "Subject to national requirements for maintaining public order...entities of transnational corporations should be given treatment accorded to domestic enterprises in similar situations".[6]

In other respects relevant to standards concerning trade in services, the United Nations draft Code is arguably more apposite than the OECD Declaration and Guidelines. For a heavily regulated industry (as are most service industries), "transparency" with respect to governmental regulation is important. It is useful, for example, for a supplier of transport or communication services to know as much as possible about proposed new regulations, and to be able to present a point of view in regard to such proposed regulations.

Transparency is, in fact, an important aspect of the OECD Guidelines; but the Guidelines are applicable to enterprises, not to States. They do not suggest that members (States) should open up the process of considering and issuing new regulations. In contrast, the United Nations draft Code stresses "the importance of endeavouring to assure the clarity and stability of national policies, laws, regulations and established administrative practices".[6] It also encourages the dissemination of "relevant information concerning decisions of competent administrative bodies".[6] There is, of course, great importance in publishing and making readily and widely available regulations which have been promulgated; the issue of the extent to which the process of arriving at such regulations should be "transparent" is a more complicated one, though it may be of equal or, in some cases, greater importance.

Symposium on the Code of Conduct, The Hague, September 1989.

These latter provisions are of more than slight importance to the service industries. Services, as noted, tend to be heavily surrounded by networks of regulatory standards, many of which are ambiguously phrased and depend for their effect on obscure interpretations made by "faceless bureaucrats". Administrative decisions and interpretations are likely to be as important as, or more important than, the published regulations—in themselves often far from models of clarity. Publication of interpretations is not often a priority matter, and even finding the text of such interpretations is often difficult. The advances made by the United Nations draft Code towards transparency are therefore not to be lightly discarded.

Conclusion

Considerations such as these have led Geza Feketekuty, Counsellor to the United States Trade Representative, to argue for a "General Agreement on Trade in Services". They argue also, in the light of the importance of the Uruguay Round, and of agreement on services to the attainment of the aims of that Round, for new efforts towards conclusion of a United Nations Code.

The useful provisions of the United Nations Code should not be discarded because of inability to reach agreement on what have come to be almost theological dogmas—"permanent sovereignty over natural resources", on the one hand, and "prompt, adequate and effective compensation", on the other. Investment disputes have been largely solv d despite theoretical adherence to those opposing criteria. The major cases involving nationalization of natural resources (for example, the Mexican oil and agrarian nationalizations of the 1930s) are no longer internationally troublesome issues. The efforts to solve national developmental problems by nationalization (Peruvian nationalization of banks, to take one instance) are now as unpopular as they were once popular. "Privatization" is the watchword of the day, in the United Kingdom as now in Eastern Europe. The measure of compensation to be used in cases of expropriation has been found to be an issue capable of agreed compromise in many a settlement. These are no longer matters which should frustrate agreement on the many rules of fair play which are present in the articles of the United Nations Code which are "concluded provisions".

Moreover, the network of bilateral and international agreements now in place and, even more, the intricate interlacing of economic interdependence which now exists argue that solutions will be found in the future, probably more easily than in the past. Additionally, the big, nasty cases are by now history. Such political investment risks as now exist (and perhaps even some economic ones, if one takes into account the concern shown for the large creditor banks) are substantially covered by insurance. Debtors recognize the value of good credit and good-faith efforts for repayment. Those key and verbally disagreed issues should not strip the international economic negotiations of the values found in a document like the United Nations Code.

Finally, it is important that that Code has been negotiated, over the course of all too many years, with the full participation of the developing countries. Those countries have always felt that the original General Agreement on Tariffs and Trade (GATT) was negotiated without their participation. Concepts such as the generalized system of preferences and part IV of the General Agreement have not satisfied their ambition to have international trade agreements which affirmatively contribute to their development. They regard the area of services trade as the one remaining field in which they have an opportunity to attain something like equality. It is far from sure that clauses such as those cited above, which are found in the United Nations draft Code, will lead to developing-country concurrence in the results of the trade negotiations on services, with all their implications of guaranties for the investor/trader. But at least they will have been negotiated in a forum which is more that of the developing countries than of the developed. This may, in the end, prove helpful. □

[5] See OECD, *International Investment and Multinational Enterprises* (Paris, 1976).

[6] See "Code of conduct on transnational corporations: note by the Secretary-General" (E/1988/39/Add.1), para. 52.

Notes from the Peace Palace

By Victoria Aranda, UNCTC

The Peace Palace, site of the International Court of Justice in The Hague. It was the venue of the Symposium on the Code of Conduct, September 1989.

The negotiations on the United Nations Code of Conduct on Transnational Corporations were initiated some 13 years ago. Their goal was to conclude an international agreement dealing with the whole range of issues arising in the relations between Governments and TNCs. Since then, the world economy has undergone a number of changes which should have a significant impact on the elaboration of international standards relating to issues being negotiated in the context of the Code.[1]

The outstanding issues[2]

While it was possible for the Intergovernmental Working Group charged with the drafting of the Code to reach agreement within a relatively short period of time on the great majority of provisions pertaining to standards of corporate conduct, a number of provisions in the part of the Code dealing with the treatment of TNCs remain to be finalized, namely, national treatment, settlement of disputes, transfer of payments and nationalization and compensation. Moreover, the finalization of the Code has been linked to the resolution of the question of an appropriate reference to international law, as the yardstick against which to measure some of the Code standards.

In that respect, the Western Group asserted throughout the negotiations that customary international law prescribes a body of principles and rules governing the treatment of foreign property and investments by Governments of host countries; those principles and rules are not limited to express commitments or obligations found in treaties, conventions, agreements or other consensual documents; in addition to the prescriptions of the Code, there must be a provision in the Code preserving the applicability of this body of customary international law. The Western Group had originally wanted such a reference to international law for the specific provisions of the Code that, in their view, raise international law issues, such as those dealing with a State's permanent sovereignty over national resources, and nationalization and compensation.

The developing countries—and, at least until recently, the Eastern European countries—have resisted this position on two main grounds. First, some countries reject the existence of any universally recognized principles of international law governing foreign direct investment. In their conception, the regulation of property relations in a State falls outside the purview of international law. Second, some developing countries contend that such international norms as exist in this area are not congruent with the traditional principles of State responsibility advocated by Western countries. Thus, Latin American countries, invoking the Calvo Doctrine, deny that international law prescribes an international minimum standard beyond the obligation to accord to aliens virtually the same treatment available to nationals.

Other developing countries maintain that such principles of international law as are applicable to international investments have undergone a change in the post-Second World War era by reason of the impact of major international developments, notably the emergence of numerous States from colonialism, and their quest for a restructured and more equitable international order. Those countries are, therefore, opposed to the stipulation of a reference to international law that is so formulated as to crystallize traditional principles and rules which do not take into account their interests.

Those countries are, however, prepared to accept a general provision enjoining States to fulfil in good faith their international obligations in matters relating to the Code. The rationale for this preference is that the term "international obligations" is perceived as having a more solid consensual basis than "international law", which is regarded as imprecise and connoting the disputed traditional doctrines of customary international law. Most of the Western countries, on the other hand, consider the term "international obligations" as rather narrow or not sufficiently explicit for their purposes.

The evolution of international law

Clues to the resolution of some of the out-

[1] This theme was analysed in detail in a number of papers submitted as background documentation to the Hague Symposium; see UNCTC, *The Hague Symposium on the Code: Compendium of Papers* (forthcoming).

[2] See UNCTC, "The outstanding issues in the United Nations Code of Conduct on Transnational Corporations", Background paper No. 2, The Hague Symposium (mimeograph).

standing issues might be found in the evolutionary nature of customary norms of international law and their direct link to state practice. Over the past two decades, transnational investment has become one of the most dynamic areas in international economic relations. Government attitudes have changed dramatically. As a result, the particular scenario of economic and political factors which prevailed when the Code negotiations were initiated may no longer be valid. For the same reason, some of the basic assumptions concerning the main outstanding issues in the Code may require reconsideration. Those considerations led a number of prominent international lawyers and government officials involved in the Code negotiations to gather at the Peace Palace with the purpose of clarifying the issues that remain to be resolved in the Code. In so doing, the group reviewed those issues in the light of recent state practice, decisions of international tribunals, treaties and other sources of international law with a view to determining the status of evolution of customary international law in relevant areas. Their findings led them to suggest ways in which the interaction between international law, national law and the Code instrument could facilitate the formulation of the Code standards.[1] This article reviews some of the outstanding issues and some of the more general aspects of the Code negotiations.

Doctrine and practice

The main positions on the international law issue in the Code negotiations described above are still a reflection of the two main doctrines that have competed in the past in the formulation of international rules concerning the treatment of foreign investors: the "international minimum standard" adhered to by the Western countries; and the "national standard", commonly known as the Calvo Doctrine, advocated by the Latin American countries. The Calvo Doctrine was the response of the newly independent States in that region to abuses of the right of diplomatic protection of foreign investors by home countries. The most authoritative award on those matters was rendered by the American-Mexican Claims Commission in the North American Dredging Company of Texas Arbitration (1926).[4]

Recent studies on the applicability of the Calvo Doctrine[5] show an evolution in the way the standard has been applied in the Latin American countries. The three main aspects of the Doctrine have developed differently, and some of them continue to adapt better to new circumstances than others. Thus, the standard of equality before the law between nationals and foreigners has been maintained as a guiding principle governing relations between host Governments and TNCs. The second component, namely, the abstention from diplomatic protection, has been applied more sparely. Subrogation by the home State of the rights of the investor has been accepted in bilateral guarantee agreements and, in the most recent practice of some countries in that region, diplomatic mediation by the home country has been recognized as a useful instrument to resolve disagreements, without necessarily complying with exhaustion of local remedies.

The principle of exclusive jurisdiction over disputes is perhaps one of the most controversial angles of the Doctrine. On the one hand, a number of countries confirm this principle in their internal legislation. On the other hand, Latin America has a long history of international conventions relating to international commercial arbitration. With respect to universal conventions, however, the region has maintained a more cautious attitude even though the arbitration system established by, for example, ICSID, is not contradictory to the Calvo Doctrine. At the same time, in the case of financial operations where the State is a party to a dispute, submission to a foreign or international tribunal has been broadly accepted by countries such as Argentina, Brazil, Chile and Peru. Thus, while some aspects of the Calvo Doctrine are still applied today (those are fully reflected in a number of Calvo-flavoured provisions in the Code, such as observance of domestic laws; submission to national jurisdiction; exhaustion of local remedies; non-discrimination[3]), this Doctrine will probably continue to evolve in an increasingly interdependent economy and adapt to the transformations that are taking place in international relations.

It would be very difficult therefore in the present circumstances to try to resolve all those problems in the Code negotiations. Instead, the Code could perhaps reflect those aspects on which agreement exists within the international community. Keeping in mind that the Code is most likely to be adopted as a voluntary instrument, the significance of this debate has perhaps been blown out of proportion. Even if it were legally binding, by keeping silent, the Code would not exclude the operation of exhaustion of local remedies, nor would it prevent any principles of international law from being applied. The best solution to this question therefore would be one that minimizes the issue rather than enhances it: a flexible formulation. The bottom line is that, when it comes to implementation, national law always applies. In that respect, the merit of the most recent formulation of paragraph 49 (1988 text), which deals with this question, is that it refers to international obligations in its first part and to international law in the second part. The two references are in a particular order. This is deliberately done in order to give priority to conventional (treaty-made) law.

Nationalization and compensation

A survey of recent developments[6] confirms that the specific content of customary international law rules pertaining to compensation upon expropriation remains unclear. Various formulations of a standard of compensation still compete for international approval. Recent arbitration cases show that a diversity of factors are considered when compensation is determined by adjudication. But cases before the Iran/United States Claims Tribunal keep reminding us that the debate continues. There are, of course, political factors that make this question more difficult to resolve, but meanwhile, most cases are actually settled on the basis of their specific circumstances rather than abstract formulations. The issue is thus very much a matter of political rather than legal judgement, though the best formulation would be a flexible one, leaving the question to judicial interpretation.

In general, judges and arbitrators have considered that a decision is better reached as the result of an inquiry into all relevant circumstances of a particular case than through abstract theoretical debates (the AMINOIL case). They have used concepts such as "market value", "going-concern value", "legitimate expectations", and "unjust enrichment" to determine what would be regarded as "just", "appropriate" or "equitable" in the circumstances of a case. In that sense Judge Largergren, commenting on five important cases before the Iran/United States Tribunal, observed that those terms are virtually interchangeable notions.[7]

At the same time, the actual number of expropriation cases submitted to international tribunals has declined dramatically in recent years. The investment climate has changed and, with it, the issue of expropriation/compensation—once among the most controversial in investor/host country relations—seems to be receding. The new

[1] See "Outcome of the Hague Symposium on the outstanding issues in the Code", below.

[3] For a detailed analysis of the applicability of the Calvo Doctrine, see P. Roffe, "Calvo y su vigencia en America Latina" (United Nations, Geneva, UNCTAD/OSG/RS/53, 1985) (Spanish only).

[4] For a detailed analysis of the Calvo Doctrine and its influence in the Code document see "The Calvo Doctrine and the Draft United Nations Code of Conduct on Transnational Corporations", *The Hague Symposium, op. cit.*

[6] For a detailed analysis of recent developments on the nationalization issue, see Oscar Schachter, "The question of expropriation/compensation in the United Nations Code in the light of recent state policy and practice", in *The Hague Symposium, op. cit.*

[7] Gunnar Largergren, Five Important Cases on Nationalization of Foreign Property (Decided by the Iran/United States Claims Tribunal), Report No. 5 (Lund, Sweden, Raoul Wallenberg Institute, 1988).

climate may provide a better opportunity for accepting compromise solutions such as that suggested in the formulation of the relevant provisions in the latest draft of the Code (paragraph 57, 1988 text).

The broader issues[8]

While discussions in the Code tend to revolve around the outstanding issues, the broader questions pertaining to matters such as the need for the Code, possible approaches to the negotiations, objectives and the current political climate, also have to be considered, for it is clear that those questions would have more impact on reaching agreement on the Code than any formulation on the individual issues. Several recent changes in the economic scene are particularly relevant to the Code. These include the growing transnationalization of economic activities and corresponding interdependence of national economies; the trend towards liberalization of national régimes with respect to foreign direct investment; the new approach to economic policy issues which emphasizes the linkages among investment, financing and trade; the on-going multilateral trade negotiations aimed at establishing an international framework on TRIMs and on trade in services; and the increasing participation of the Eastern European countries in the world economy. All these and other developments have rendered the need for the Code, that is, a global, comprehensive and balanced framework on foreign direct investment, more acute than ever before, because they emphasize the growing significance of TNCs in the world economy and increase the importance of concluding international standards to guide essential economic functions undertaken by those corporations

This is all the more so since the fundamental need of the international community to address the consequences of the operations of TNCs has not changed. A recent study by UNCTC[9] has identified a number of changes also in contemporary TNCs, which have given rise to new challenges that the international community should address. Those changes reflect the flexibility shown by TNCs in adopting different forms of ownership structures, organizational patterns and modes of operation. The new types of TNCs and the new patterns of such corporations—that is, non-equity forms of investment, intercorporate alliances—make their decision-making even more elusive than before. It could be argued, therefore, that the new forms of TNC operations and structures would not take away much of the apprehension of Governments of host countries towards these corporations, because they simply suggest the superiority of TNCs over States in responding efficiently to new conditions. The new problems are not likely to diminish the importance certain Governments attach to maintaining the original objectives of the Code. Moreover, attempts to apply national laws to the new array of intercorporate alliances could raise jurisdictional issues more complex than those experienced in the past. If anything, therefore, these changes have emphasized the need for a global international framework for dealing with such potential difficulties.[10]

Thus, while discussions on the Code tend to focus primarily on the treatment of TNCs by host countries, because most of the outstanding issues in the Code relate to that aspect, commentators[10] have stressed

[8] In her analysis of the broader issues, the author draws mainly from discussions during the Hague Symposium.

[9] See John Kline, "The new Code environment", *The Hague Symposium, op. cit.*

[10] See statement by Sten Niklasson, Chairman, Intergovernmental Working Group on the Code of Conduct, at the Hague Symposium, *The Hague Symposium, op. cit.*

Hearings on the Code:

Excerpts from the testimony of Seymour J. Rubin

Seymour J. Rubin

It is my opinion that what has always been the stated objective of the United States—to achieve a useful and balanced Code—lies within present reach...

...While it would be useful to have explicit reference in the Code to "international law" rather than "international obligations" as a standard, I believe that the difference is neither clear nor vital.

In the opinion of many if not most persons dealing responsibly with matters of international law, including many from developed nations, there is substantively little difference between the two phrases—unless "international obligations" is qualified by such limitations as "freely agreed", which raises a number of doubts.

Moreover, it must be recognized—even if we in the United States do not like it—that the vast majority of the nations of the world—again I include many developed nations—or, at any rate, their scholars and their Foreign Offices—do not concur in our definition of the "international law" applicable to non-discriminatory expropriation for legitimate social purposes. Since *opinio juris* is acknowledged as one of the major sources of international law, we cannot be sure that a standard which refers to international law will always be interpreted in accordance with our views—which, indeed, are themselves not unanimous. We can, however, be sure that our interpretation will be hotly contested.

...The Code, in its present form (and it could be somewhat improved) reflects many United States positions and has substantial advantages for the United States.

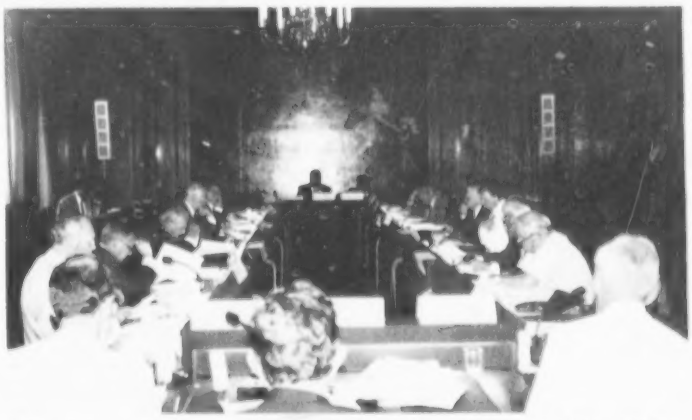
In the first place, one must recall that efforts to establish an international code dealing with foreign investment, if not with transnational corporations, were originally an American initiative.

As early as 1947-1948, in the negotiations for GATT and the International Trade Organization, the United States proposed clauses dealing with private foreign investment, some of which had to do with the conduct of the investor. As to regulating or supervising the conduct of the foreign investor, it must not be forgotten that it was the United States which proposed in the United Nations Commission on Transnational Corporations a code on illicit payments. It is certainly true that the American position was mainly that private foreign investment should be protected, but it was always recognized that some element of supervision was an essential counterpoint.

...We have come a long way since the 1970s. The Code provisions on the activities of transnational corporations are not only largely agreed, but they reflect United States views on corporate conduct generally—domestic as well as foreign. After all, it has been the United States which has developed concepts of full disclosure, fair treatment of labour, consumer protection, environmental responsibility and the like. For example, the disclosure requirements of the Code are neither mandatory (as such requirements are domestically) nor nearly as far-reaching as those of either the Securities and Exchange Commission or the accounting profession in the United States.

So the Code as it now stands derives more from American doctrine, worked out in the practical laboratory of a free-enterprise

that it is crucial to keep in mind that one of the main objectives of the Code is to supplement national law with international standards for the conduct of TNCs. That remains important because national laws do not normally reach the operations of TNCs beyond their national frontiers, even though operations conducted abroad can have a profound impact on national economic and social conditions. States could try to imitate the way TNCs use their dual structure—that is, as legally separate national companies established in accordance with different national laws, on the one hand, and as a group of entities which are part of a unified structure with common control and strategy, on the other—by submitting the international operations of TNCs to international standards of conduct. Otherwise, the national State will see its sovereignty deteriorate. This assertion is valid for all countries whether large or small, developed or developing, socialist or market-oriented.



The Hague Symposium was meant to facilitate the negotiations on the code by reviewing the outstanding issues in the light of recent developments in international law and practice.

The general wisdom now agrees that the best solution to the Code is to conclude it as quickly as possible, and to provide it with a mechanism which ensures its continuous adaptation to changing conditions. As to the technical form that should be used for the adoption of the Code, the various views coincide that it should be one which lends momentum to the Code's process and prevails upon Governments to adopt it. Moreover, the final text of the Code should be acceptable to the greatest possible number of States, including the larger capital-exporting and capital-importing countries, in order to provide maximum moral authority to the instrument.

But the success of the Code negotiations can only be ensured by the political willingness to reach agreement on the part of Governments. The best, most flawless legal texts cannot, by themselves, create this political will. In fact, agreement on the Code is likely to be found by means of flexible formulations that accommodate different views rather than on the basis of the legal merits of one or another alternative. □

system which recognizes the essential role of government in establishing standards of conduct, than it does from the overreaction of the 1970s.

The Code is now reasonably balanced. It is clearly not going to be mandatory. It reflects standards long in use in the United States. Its existence defuses what might otherwise be a tendency of some countries towards excessive national legislation.

...Obviously, world economic circumstances have changed. The United States is now the world's largest debtor. We still have extensive private holdings abroad, and that situation will no doubt continue; but we also have extensive foreign holdings in the United States, and those are rapidly growing. Books and articles like *The Selling of America*, not to speak of legislation in the Congress, makes this point evident.

One can debate the merits of this foreign investment in America, and indeed, I am not one who worries about it. But its presence makes a Code more relevant to the United States than was the case a few years ago. We are now, more than ever, a host as well as a home nation. As such, we should not lightly discard provisions relating to the activities of transnational corporations.

Even more, the United States should note that the United Nations Code—like the OECD declaration and guidelines—is relevant to an increasingly important subject—trade in services. The United States has in fact recently put forward a proposal for a General Agreement on Trade in Services under GATT. Trade in services is by its nature heavily dependent on investment. Both the OECD Declaration and the United Nations Code look toward national treatment, though it would be an exaggeration to say that either guarantees it. For American companies which are anxious to keep open channels to trade in services, the United Nations Code draft provides at the very least a starting point.

The current United Nations draft, after stating the obvious right to regulate entry, goes on to provide "fair and equitable treatment"—a commitment which is actually beyond any found in the OECD Declaration. The United Nations document then goes on, in a manner similar to that of the OECD, to say that "entities of transnational corporations should be given treatment accorded to domestic enterprises in similar circumstances". The limitation, the requirements of public order, is hardly unreasonable.

Moreover, the United Nations draft would make the process of government decision-making more open to inspection. "Transparency" with respect to governmental decisions is extremely important in the services field. Trade barriers as to goods are likely to be more or less obvious: one knows what the tariff rate is, or whether quotas exist. In the case of services, where the industry is likely to be heavily regulated, barriers may be less evident. In that respect, the United Nations Code is substantially better than the OECD actions: in the OECD, transparency is in the "guidelines", which are applicable to enterprises; in the United Nations Code, the relevant provisions stress the "importance of endeavouring to assure the clarity and stability of national policies, laws, regulations and established administrative practices..." The provisions go on to encourage the dissemination "of relevant information regarding decisions of competent bodies..."

All this demonstrates that private enterprise has not collapsed as a result of the failure of the international lawyers to agree on the exact wording of the obligation to deal fairly with overseas investment in regard to the right to nationalize and the duty to compensate. Nor is it likely to collapse, or even seriously impede, the flow of investment abroad. Within the Code itself, significant and useful progress has been made. The Code contains clauses—particularly those relating to the right of establishment—which can be very useful to attainment of a general agreement on trade in services—a matter of some importance to the United States. And surrounding the Code negotiations is a world vastly more realistic than that of some 12 years ago, a world in which developing countries—and now members of what used to be called the Soviet Bloc—are eager to receive foreign investment.

Outcome of The Hague Symposium on the outstanding issues in the Code

The need for the Code

The participants endorsed the validity of the code exercise in the contemporary international economic environment. The Code is as critical today as it was at the inception of the negotiations some 13 years ago. Current international developments, such as the increased internationalization of economic activities, the phenomenal growth in the volume of trade and FDI flows, the emergence of services as an important component of FDI and trade, and indeed the entire phenomenon of increasing interdependence in the world economy, all underscore the importance of TNCs as major actors in the world economy. Those trends reinforce the need for an international framework for the operations of TNCs.

The outstanding issues

The participants found no fundamental technical flaw in the basic approach of the Commission on Transnational Corporations as to the outstanding issues. While some of the formulations could be refined or improved upon, the essential format of the provisions on the outstanding issues was considered feasible. If there were any impediment to the conclusion of the Code, it derived from the lack of political commitment of the negotiating parties to the Code and not the technical defects of the formulations. Conversely, flawless drafting could not by itself assure finalization of the Code if the political will of the member countries were non-existent.

1. The question of a reference to international law/international obligations

The importance of stipulating a reference to "international law" or "international obligations" in the Code was underscored, although it was recognized that such a provision need not elaborate the substantive content of such law. After reviewing the debate on the doctrinal implications of referring to international law or international obligations, it was pointed out that, for the purposes of the Code, the distinction between international law and international obligations was not essential. This was because obligations of States with respect to foreign investment do not merely include obligations founded on conventional law, but also obligations derived from customary international law. On the other hand, a State's obligations under international law must necessarily encompass its conventional as well as its customary legal obligations.

The discussion on this issue revolved around the text of paragraph 49 of the Chairman's draft, *viz.*:

> "In all matters relating to the Code, States shall fulfil, in good faith, their international obligations, including generally recognized and accepted international legal rules and principles."

It was suggested that the words "and accepted" in the context of that provision departed from the established phraseology in connection with the validity of international legal rules and principles, and should accordingly be deleted. It would be enough to retain the phrase "generally recognized", which had a clear technical connotation. With a further amendment, which was purely editorial, paragraph 49 should read as follows:

As one of the most dynamic areas in international relations, transnational investment has witnessed significant changes in government attitudes. This might affect some of the earlier assumptions in the Code negotiations.

> "In all matters relating to the Code, States shall fulfil, in good faith, their international obligations, including those arising from generally recognized international legal rules and principles."

The amended text commanded general support, but other alternative formulations were suggested, namely:

(a) "In all matters relating to the Code, States shall fulfil, in good faith, their obligations under international law."
(b) "In all matters relating to the Code, States shall fulfil, in good faith, their international obligations."

With regard to those formulations, it was pointed out that the terms "international obligations" or "obligations under international law" should not be construed as implying the internationalization of all obligations, such as obligations arising under contracts between States and transnational corporations.

2. Non-interference in internal political affairs

The importance of prohibiting TNC interference in the national affairs of host States was acknowledged. A question was raised as to whether the concept of non-interference was feasible, since it could imply severe limitations on normal business relations between a TNC and its host State. However, it was the overwhelming sense of the Symposium that the formulations of the Code, namely, paragraphs 16 and 17 of the Chairman's draft, accommodated any legitimate corporate activities in the host State and were broad enough to encompass the divergent policies and practices of host countries in this regard.

Paragraphs 16 and 17 read as follows:

"16. Transnational corporations shall not interfere in the internal affairs of host countries, without prejudice to their participation in activities that are permitted by the laws, regulations or established administrative practices of host countries."
"17. Transnational corporations shall not engage in activities of a political nature which are not permitted by the laws or

established policies and administrative practices of the countries in which they operate."

It was felt that the above provisions captured the essence of the basic idea of the prohibition against corporate interference in internal political affairs, and that it was impractical to itemize categories of prohibited activities. However, with regard to paragraph 16, it was suggested that the words "permissible under the laws" be substituted for the words "permitted by the laws", since activities which have not been expressly permitted may nevertheless be permissible because they have not been explicitly prohibited

3. Respect for national sovereignty

The main issue which arose with respect to the discussion of paragraph 7 of the Chairman's text was whether the provision on permanent sovereignty over natural resources would be unequivocally qualified by a reference to international law. Since the basic approach of the Commission was to stipulate one omnibus provision on international law/obligations (paragraph 49), a clear linkage between paragraph 7 and paragraph 49 was recognized. The text of paragraph 7 (see below) was considered acceptable if read in conjunction with paragraph 49 on international law, and also paragraph 6, which underscores the interrelated nature of all provisions of the Code.

Paragraph 7 states:

"Transnational corporations shall respect the national sovereignty of the countries in which they operate and the right of each State to exercise its permanent sovereignty over its natural wealth and resources."

4. Nationalization and compensation

The sovereign right of a State to nationalize or expropriate the assets of a transnational corporation operating in its territory was recognized. It was also recognized that this must be coupled with a duty to pay compensation.

The participants felt that it was not feasible to spell out elaborate and specific principles on the standard of compensation, and that a general and flexible standard would be adequate, particularly in view of the provision on observance of international law/obligations (para. 49).

Accordingly, it was considered that paragraph 57 of the Chairman's text of 1988 was acceptable. That provision reads as follows:

"It is acknowledged that States have the right to nationalize or expropriate the assets of a transnational corporation operating in their territory, and that appropriate compensation is to be paid by the State concerned, in accordance with the applicable legal rules and principles."

It was pointed out that the phrase "applicable legal rules and principles" embraced international as well as municipal legal rules and principles.

The point was made that the assets of a transnational corporation that may be nationalized or expropriated must be in the territory of the nationalizing State. However, this issue has been subject to different judicial decisions in different circumstances and need not be dealt with specifically in the Code.

5. Dispute settlement

The basic principles set forth in paragraph 59 of the Chairman's text were found acceptable. Paragraph 59 provides that:

"Disputes between States and entities of transnational corporations, which are not amicably settled between the parties, shall be submitted to competent national courts or authorities. Where the parties so agree, or have agreed, such disputes may be referred to other mutually acceptable dispute settlement procedures."

Participants at the Symposium

Marino Baldi	Sten Niklasson
Miguel Marin Bosch	Paul Peters
Ian Brownlie	C. W. Pinto
José Sette Camara	Seymour J. Rubin
Detlev Chris Dicke	Oscar Schachter
Hector Ditella	Nico J. Schrijver
Arghyrios Fatouros	V.D. Shchetinin
Adriaan Gautier	Pieter Verloren Van Themaat
Rainer Geiger	Paul De Waart
Günther Jaenicke	

The first part of this provision provoked little comment. As to the second part, there was some concern as to whether the provision for referring disputes to "other mutually acceptable dispute settlement procedures" could not be construed so as to frustrate a prior agreement to submit to arbitration. This was because there was some question as to whether the second sentence of paragraph 49 envisaged two separate steps in the process, namely, an agreement to submit to arbitration and a subsequent agreement on the dispute settlement procedure or mechanism. It was pointed out that two such steps were not envisaged under the provision. It was understood that an agreement to submit to arbitration would cover both of those steps at the same time. Furthermore, the second sentence admitted of a choice of dispute settlement procedure either before or after a dispute arises.

Finally, the term "other dispute settlement procedures" clearly included international arbitration.

6. National treatment

The question was raised as to whether a provision on national treatment (paragraph 52 of the Chairman's text) was necessary in view of the agreement on paragraph 51 requiring "fair and equitable treatment" for transnational corporations, which is understood to imply non-discriminatory treatment.

If paragraph 52 were to be retained, however, it was suggested that it could be amended to read as follows:

"Subject to national requirements for maintaining public order and protecting national security and consistent with national constitutional law and basic laws, and without prejudice to measures specified in legislation and declared policies relating to the development objectives of developing countries, entities of transnational corporations should be entitled to treatment accorded to domestic enterprises in similar circumstances."

There was considerable debate as to whether it was necessary to provide for the possibility of preferential treatment of foreign investors as stated in the last sentence of paragraph 52, which reads as follows:

"Nothing in this paragraph should be construed as excluding the right of the host country to grant such special incentives and facilities to transnational corporations as may be considered necessary in its national interest."

The necessity of such a provision was questioned by some participants. □

TNCs IN THE WORLD ECONOMY

Overall trends of foreign direct investment*

By Paz Estrella E. Tolentino, UNCTC

After having tripled between 1984 and 1987, world-wide outflows of FDI grew only by 4 per cent in 1988 to an absolute level of $150 billion (see table). The slow-down in the growth rate resulted mainly from the absolute decline of outflows from the United States and the United Kingdom by $26 billion and $3 billion respectively. That decline was partially offset by significant increases in outflows of FDI from other home countries, including Canada, France, Japan and in particular smaller countries of Western Europe such as Finland, Italy, Sweden and Switzerland. The latter group of countries increased their outward investment flows in 1988 by $12 billion. The decline in United States outflows in 1988 was owing mainly to two factors: net equity capital disinvestment (particularly in such industries as petroleum, finance and insurance in Colombia, the Federal Republic of Germany, the Netherlands Antilles and the United Kingdom) and lower reinvested earnings primarily caused by the appreciation of the United States dollar in 1988 and by relatively higher interest rates in the United States than abroad.

Developing countries are becoming a more important source of outward investment. In 1988, outward flows from developing countries more than doubled, increasing by $3.5 billion to a total of $5.8 billion. This sudden upsurge, however, has not yet affected their small share of 2 per cent of total outflows, a share that persisted throughout the 1980s. Most of the increase was accounted for by Eastern and South-East Asian countries and, in particular, Taiwan Province of China. The increase of outward FDI from some newly industrializing and middle-income developing countries may well continue into 1989, as there have been reports of large actual or planned acquisitions of companies in developed countries by firms from developing countries, particularly from Mexico, Nigeria, Saudi Arabia, Taiwan Province of China and Venezuela.

Increased inflows of FDI have been experienced by both developed and developing countries. Since the mid-1970s, however, the share of inward flows directed to developed countries increased from an average share of 73 per cent during the period 1981-1983 to 80 per cent during the period 1984-1988. The share of five major investor countries in particular (the Federal Republic of Germany, France, Japan, the United Kingdom and the United States) increased from 53 per cent in 1981-1983 to 57 per cent in 1984-1988. Such growth is accounted for mainly by the strong growth of inward investment in the United States in 1988 which further enhanced the position of that country as the world's largest host country.

Since 1983, the absolute level of inflows of FDI to developing countries has also been increasing, to a level of $25 billion in 1988, a 7 per cent growth over 1987 (see table). In 1988, flows increased to all regions of developing countries except Latin America. South and South-East Asia outstripped Latin America as the largest host region among developing countries. There was also an increase of inflows to Africa for the second consecutive year. In relative terms, however, the share of developing countries in total inflows of FDI declined from an average share of 27 per cent during the period 1981-1983 to 20 per cent in 1984-1988. This is owing largely to the increasing importance of technologically intensive direct investments during the 1980s which favour locations in other developed countries and the less favourable investment climate in developing countries owing to their heavy debt burden and/or political and economic instability.

The share of the developing countries in total flows was likely to fall further in 1989, since inflows to China decreased during that year. Since the inception of its foreign investment policy in 1979, China has become a major host to foreign investment in both absolute and relative terms. Foreign investment inflows into China reached $3.2 billion in 1988, representing a share of 12 per cent of all inflows to developing countries during the period 1984-1988, compared to 4 per cent during the period 1981-1983. In 1989, however, the influx of new FDI slowed markedly as a result of a perception of a less favourable investment climate. In addition, the flow of new financial resources to China from international banks and multilateral agencies sharply declined during the third quarter of 1989.

Perhaps the most important new development during the past two years has been the emergence of Eastern Europe and the USSR as more important host areas for FDI. Virtually all countries of that area have now introduced and/or improved laws and regulations aimed at attracting FDI, typically in the form of joint ventures. In addition, a number of those countries have established (Bulgaria, Hungary and Poland) or are considering (USSR) free economic zones which may significantly broaden investment opportunities for TNCs. All of those countries place special emphasis on the role of TNCs in contributing capital, technology and management expertise, as well as providing access to markets, as part of the domestic restructuring process and as a mechanism for further integration into the world market and the international division of labour. Accordingly, various incentives and guarantees are offered (including bilateral investment protection treaties), and promotional activities are undertaken to obtain as rapidly as possible the desired influx of FDI.

How successful those efforts will be remains to be seen. Success may well depend on how fast workable market mechanisms will be introduced in those countries and, above all, how fast convertibility of their currencies can be enhanced (or other mechanisms can be found, *inter alia*, to permit the transfer of profits). A

* Excerpted from the Secretary-General's report (E/C.10/1990/2) to the sixteenth session of the Commission on Transnational Corporations.

Table. Foreign direct investment flows 1983-1988
(Billions of United States dollars)

Country/region	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1981-1983*	*1984-1988*
			Foreign direct investment inflows				*Annual average*	
Developed countries	33.5	38.6	35.7	63.6	94.5	118.8	35.3	70.2
France	1.7	2.4	2.6	3.2	5.1	8.5	1.9	4.4
Germany, Federal Rep. of	1.6	0.6	0.6	1.0	2.0	1.7	0.9	1.2
Japan	0.4	–0.01	0.6	0.2	1.2	–0.5	0.3	0.3
United Kingdom	5.2	–0.3	4.7	7.1	13.3	13.1	5.4	7.6
United States	12.0	25.3	19.2	33.7	46.8	58.5	17.1	36.7
Developing regions	10.4	12.0	13.3	13.9	23.6	25.1	13.2	17.6
Africa	1.2	1.4	2.6	1.8	2.2	2.9	1.4	2.2
South-East Asia	4.7	5.1	4.6	5.7	10.1	12.3	5.0	7.6
Western Asia	0.3	0.7	0.4	0.3	0.2	0.4	3.7	0.4
Latin America	4.0	4.7	5.6	6.1	10.8	9.3	6.3	7.3
Oceania	0.2	0.1	0.1	0.1	0.1	0.2	0.1	0.1
Eastern Europe	0.02	0.03	0.02	0.02	0.01	0.01	0.02	0.02
TOTAL	43.9	50.7	49.0	77.5	118.1	143.9	48.6	87.8
			Foreign direct investment outflows					
Developed countries	35.8	41.4	56.6	90.6	142.1	144.3	40.3	95.0
France	1.7	2.1	2.2	5.3	9.1	14.5	3.0	6.7
Germany, Federal Rep. of	3.2	4.3	4.9	10.1	9.2	10.4	3.2	7.8
Japan	3.6	5.9	6.4	14.3	19.4	34.3	4.3	16.1
United Kingdom	8.2	8.0	11.2	16.2	30.5	27.2	9.2	18.6
United States	3.6	4.9	13.5	21.4	41.2	14.8	7.5	19.2
Developing regions	0.9	0.6	1.2	1.3	2.3	5.8	0.7	2.2
Africa	0.06	0.06	0.04	0.05	0.1	0.04	0.08	0.06
South-East Asia	0.3	0.3	1.0	0.8	1.9	5.4	0.3	1.9
Western Asia	0.2	0.1	0.07	0.3	0.1	0.3	0.07	0.2
Latin America	0.3	0.08	0.1	0.2	0.2	0.1	0.3	0.1
Oceania	0.001	0.003	0.001	–0.008	–0.02	0.03	0.001	0.002
Eastern Europe	0.001	0.01	0.001	0.02	0.008	0.02	0.003	0.01
TOTAL	36.7	42.0	57.8	92.0	144.4	150.1	41.1	97.3

Source: International Monetary Fund, balance of payments tape, data retrieved in January 1990 and OECD estimates.

number of pre-conditions are, however, quite favourable: the countries of Eastern Europe, and in particular the USSR, represent a large, relatively untapped market; skills are abundant and wages are relatively low; an industrial infrastructure and technical culture exist; and the close proximity to the Western European market is unrivalled. The last of these facts—of course in combination with the others—is likely to become particularly important in the light of the intensified competition likely to result from the completion of the single European market at the end of 1992. Firms that are subject to increased competition in the European Community will search for highly skilled labour and low-cost sites of production. They may be especially interested in investing in Eastern Europe and the USSR (or expanding sub-contracting and other non-equity relationships with enterprises in that area) to preserve or enhance their competitive position, provided, however, access of exports from Eastern Europe and the USSR to the Western European market is assured.

All indications are that Eastern Europe and the USSR will, indeed, become more attractive host areas. For example, the number of joint venture agreements signed with Soviet firms increased from 300 at the beginning of 1989 to 1,200 at the end of that year. By August 1989, approximately $4 billion had been committed to joint ventures in the USSR, but only a few of the projects have actually become operational. The number of joint ventures in Hungary doubled in 1989, to more than 600 as of October 1989, although many are small. In the case of Poland, 866 joint ventures had been approved by the end of 1989, compared to a total of 16 in 1987. Although the constitution of the German Democratic Republic was changed in January 1990 to permit FDI, negotiations on a number of joint ventures with firms in that country had already begun. The massive capital assistance that countries of Eastern Europe are in the process of obtaining from OECD countries is most likely to be an additional stimulus to FDI. Although those developments have not yet been reflected in any foreign-direct-investment statistics, they are very likely to become increasingly a factor in global resource flows. In particular, investments may be attracted which are meant to serve the domestic markets of Eastern Europe and, more so, the USSR market, but a sizeable share of those investments is also likely to be export-oriented, in both the natural resource and manufacturing sectors. It may be useful to examine to what extent countries of Eastern Europe and the USSR will indeed attract TNCs and what implications this may have for foreign-direct-investment flows to other parts of the world. □

FDI in the United States

The recent upsurge of foreign investments in the United States has given rise to public concerns similar to those in Western Europe some 25 years ago. That region feared the "American challenge" and the popular impression was that United States firms were in the process of taking over the region's industry. It was widely predicted that: "Fifteen years from now the world's third greatest industrial power, just after the United States and Russia, may not be Europe, but *American industry in Europe*".[1] Today, public discussions in the United States often create the impression that the United States is on the verge of becoming the victim of a "non-American challenge". In particular, the acquisition of large and visible United States assets has caught public attention and has induced a political debate about FDI in the United States.

The surge of inward investment in the United States since 1986 and, in particular, the growth of takeovers of United States companies by foreign companies has resulted in several legislative proposals seen to impose restrictions on FDI in key industries. The first proposal, the Bryant Amendment to the 1988 Omnibus Trade Bill, reintroduced as House Resolution 5410, was defeated during the Congressional debate on the grounds that it contained provisions which might discourage foreign investment and violate the national treatment clause of various United States international treaties and agreements. Those provisions would have required foreign companies that have a significant or controlling interest in a United States business enterprise to register with the Department of Commerce and to disclose confidential and proprietary information.

Another legislative proposal, the Exon-Florio provisions, was included in the Omnibus Trade and Competitiveness Act of 1988 as Section 5021. It extends the powers of the United States President to review certain mergers, acquisitions and takeovers by foreign interests with respect to their effect on national security. The provisions have been used to scrutinize the national security implications of foreign takeovers of United States companies rather than to discourage or block them. Of the 100 voluntary notifications of planned investments by foreign companies to the United States Committee on Foreign Investment in 1988-1989, only one case was perceived as involving a national security risk. That was the proposed takeover of General Ceramics, a company with a unit producing components for nuclear warheads, by Tokuyama Soda of Japan; the takeover was subsequently approved after changes which excluded the purchase of the sensitive unit.

There are other legislative proposals pending in the Congress of the United States relating to foreign investment. One proposal, HR 3699, seeks to amend the Trade Act of 1974 by calling for reciprocal treatment with respect to foreign acts, policies and practices that deny national treatment to United States investments. Another proposed bill, known as the Cable Television Ownership Act of 1989 (HR 3265), seeks to amend the Communications Act of 1934 by calling for prohibition of foreign ownership in cable television systems.

Despite those legislative initiatives, the United States remains one of the most open countries to FDI. Nevertheless, the debate has not subsided and proposals for closer monitoring of FDI continue to be discussed because of the growing perception that parts of the United States economy are coming under the control of foreign investors.

Such perceptions are unfounded if one examines the relative importance of FDI in the United States compared to many other developed and developing countries. A comparison with other major host countries of the overall role of FDI in the United States shows that foreign firms play a much less significant role in the United States economy than in many other major developed and developing host countries. For example, while foreign firms accounted for only 7 per cent of total employment in the United States manufacturing sector in 1987, the foreign share of manufacturing employment in Australia, Belgium, Brazil and Canada was between 22 per cent and 45 per cent in the late 1970s and early 1980s. Other major host countries in which foreign firms play a considerably more important role than in the United States are France, Malaysia, Mexico, the Netherlands and the United Kingdom. A similar pattern emerges when other measures, such as the share of sales or assets accounted for by foreign affiliates, are used for comparison.

Furthermore, the importance of United States direct investment alone in other major partner countries is usually far greater in terms of its ratio to the host country's gross domestic product than the importance of those countries' investments in the United States economy. For instance, the ratios of direct investment holdings of the United Kingdom, the Netherlands and Canada in the United States to that country's gross domestic product are 1.7 per cent, 1.0 per cent and 0.5 per cent, respectively. By comparison, the ratios of direct investment holdings of United States companies to the gross domestic product in those countries are 6.6 per cent, 6.6 per cent and 13.7 per cent, respectively.

Recent discussions in the United States have particularly focused on the inflow of Japanese investment. The focus on Japan stems from the very rapid growth of Japanese FDI; its concentration in some areas, industries and companies considered sensitive or vital to United States interests; and the perceived imbalance in foreign-direct-investment activities between the United States and Japan. The article on FDI between Japan and the United States addresses those issues. □

[1] J. J. Servan-Schreiber, *The American Challenge* (New York, Avon Books, 1969), p.35.

FDI between Japan and the United States

By Masataka Fujita, UNCTC

During the 1980s, Japan joined the ranks of major capital exporters and is now one of the world's largest home countries for foreign direct investment (FDI). The United States has become a major host country to TNCs from Japan. At the same time, United States-based TNCs maintain a significant share in total inward FDI in Japan. This article presents and analyses data on FDI between Japan and the United States.

Trends and patterns of Japanese and United States FDI

During the 1980s, the transnational activities of Japanese TNCs have become more prominent. At the same time, the United States has grown in importance as a host country, while in Japan, the level of inward FDI is relatively small.[1] The inflow of FDI into the United States is equal to about 7 per cent of United States' private gross fixed capital formation, which is more than 10 times as high as in Japan.

Data reported by Japan's Ministry of Finance (on approval/notification basis) and the United States Department of Commerce reveal that FDI from Japan and the United States is increasing in each host country (table 1). As of March 1989, the stock of Japanese FDI in the United States accounted for 39 per cent of the total stock of Japanese FDI, while 5 per cent of the total stock of United States FDI was in Japan at the end of 1988. Nearly half of all outflows of Japanese FDI since the mid-1980s have been to the United States, and about 16 per cent of total inward FDI stock in the United States was from Japan as of 1988. Among foreign investors in Japan, the United States has been the largest investor, accounting for one half of the total inward FDI.

The level of United States FDI in Japan has been only one tenth to one third of Japanese FDI in the United States, depending on which country's data are used (table 1).[2] According to the United States Department of Commerce, until 1980, United States FDI in Japan was larger than Japanese FDI in the United States. In fact, dramatic increases in Japanese FDI in the United States occurred only after 1985, following the depreciation of the dollar. The data from Japan's Ministry of Finance suggest that about 65 per cent of Japan's

[1] See UNCTC, *Transnational Corporations in World Development: Trends and Prospects* (United Nations publication, Sales No. E.88.II.A.7), especially chapter V.

Table 1. FDI between Japan and the United States

	Reported by Japan[a]				*Reported by the United States*[b]			
	FDI by Japan in the United States		*FDI by the United States in Japan*[c]		*FDI by Japan in the United States*		*FDI by the United States in Japan*	
Year	*Millions of dollars*	*Percentage share in total FDI*	*Millions of dollars*	*Percentage share in total FDI*	*Millions of dollars*	*Percentage share in total FDI*	*Millions of dollars*	*Percentage share in total FDI*
				Flows				
1980	1 484	31.6	104	34.7	948	5.6	19	—
1981	2 354	26.4	149	34.5	2 970	11.8	488	3.8
1982	2 738	35.5	249	33.2	1 977	14.3	243	3.9
1983	2 565	31.5	432	53.1	1 653	13.8	1 257	337.0
1984	3 360	33.1	214	43.4	4 374	17.2	–361	—
1985	5 395	44.2	413	44.4	3 394	17.8	1 160	6.4
1986	10 165	45.5	488	51.9	7 268	21.3	1 987	7.6
1987	14 704	44.1	938	42.4	7 504	16.0	2 908	6.6
1988	21 701	46.2	1 774	54.7	17 838	30.5	1 976	11.3
				Stock				
1975	3 418	21.4	900	60.0	591	2.1	3 339	2.7
1980	8 878	24.3	1 611	54.1	4 723	5.7	6 225	2.8
1986	35 455	33.5	3 407	48.6	26 824	12.2	11 472	4.4
1987	50 159	36.0	4 010	47.4	35 151	12.9	14 671	4.8
1988	71 860	38.6	6 288	49.0	53 354	16.2	16 868	5.2

[a] Ministry of Finance of Japan, *Taigai Oyobi Tainai Chokusetsu Toshi Todokede Jisseki (Results of Reported Outward and Inward Direct Investment)*, various issues. Fiscal year. Figures are based on approval/notification, thus presumably larger than actual figures. Reinvested earnings are excluded.

[b] United States Department of Commerce, *Survey of Current Business*, various issues.

[c] Before 1985, loan investment (loan lending) is not included. Thus, figures indicate only acquisition of stocks. In stock data, figures are only for acquisition of stocks.

FDI stock in the United States is from inflows during the period from 1986 to 1988.

Most of Japanese inflows into the United States consist of new capital, as reinvested earnings from prior investments are quite small.[3] That is because Japanese FDI in the United States was not large in the 1970s and early 1980s. On the other hand, United States FDI flows into Japan have been largely financed by reinvested earnings from past investments.[4] The implication of that is clear: even if current United States FDI flows to Japan are small compared to Japanese FDI in the United States, the economic impacts from United States affiliates in Japan are still substantial.

Table 2. Stock of Japanese FDI in the United States and United States FDI in Japan, reported by the Department of Commerce, 1987
(Millions of dollars)

Industry	*Japanese FDI in the United States*	*United States FDI in Japan*
Petroleum	30	2 561
Manufacturing	5 232	7 073
Food and kindred products	164	365
Chemicals and allied products	534	2 093
Primary and fabricated metals	577	173
Machinery[a]	1 521	[b]
Other manufacturing	2 436	[b]
Services	27 830	4 636
Wholesale trade	14 667	2 934
Banking	3 402	343
Finance (except banking), insurance and real estate	7 074[c]	945
Others[d]	2 687	414
All industries	33 361	14 270

Sources: United States Department of Commerce, "Foreign direct investment in the United States: detail for position and balance of payment flows, 1987", and "U. S. direct investment abroad: detail for position and balance of payments flows, 1987", *Survey of Current Business* (August 1988).

[a] Electric and non-electric machinery.

[b] Suppressed to avoid disclosure of data of individual companies.

[c] Data for insurance are suppressed to avoid disclosure, and are thus excluded in this figure.

[d] Includes agriculture, forestry and fishing, which are not separately available. Figures are considered negligible.

Table 3. The share of host country production in total sales of Japanese/United States manufactured goods in the United States/Japan 1977—1986
(Percentage)

Industry	*Sales of Japanese affiliates in the United States as percentage of total sales by Japanese companies in the United States*[a]			*Sales of United States affiliates in Japan as percentage of total sales by United States companies in Japan*[b]		
	1977	*1980*	*1986*	*1977*	*1980*	*1986*
Chemicals and related products	20.6	35.4	28.4	79.3	70.6	72.0
Primary and fabricated metals	20.4	19.6	42.1	86.3	60.3	80.4
Machinery, except electrical	14.0	11.9	7.8	75.0	64.0	74.7
Electric and electronic equipment	5.4	12.3	9.5	65.5	65.6	73.7
Transport equipment	[c]	[c]	[c]	92.1	92.7	92.7
TOTAL	13.6[d]	16.2[d]	15.1[d]	81.5	78.2	83.3
All manufacturing[e]	9.8	10.6	12.0	82.5	76.1	81.5

Sources: Data on exports and imports data from United States Department of Commerce, *Highlights of U. S. Export and Import Trade*, December issues of corresponding years; sales of affiliates data from United States Department of Commerce, *Foreign Direct Investment in the United States: Operations of U. S. Affiliates, 1977-80* (Washington, D. C., 1985), *Foreign Direct Investment in the United States: Operations of U. S. Affiliates of Foreign Companies, Preliminary 1986 Estimates* (Washington, D.C., June 1988), *U. S. Direct Investment Abroad, 1977* (Washington, D.C., April 1981), *U. S. Direct Investment Abroad: 1982 Benchmark Survey Data* (Washington, D.C., December 1985); and *U. S. Foreign Invesment Abroad: Operations of U. S. Parent Companies and their Foreign Affiliates, Preliminary 1986 Estimates* (Washington, D. C., june 1988).

[a] Manufacturing sales of Japanese affiliates in the United States/ (Imports of manufactured goods from Japan into the United States + Manufacturing sales of Japanese affiliates in the United States).

[b] Manufacturing sales of United States affiliates in Japan (Exports of manufactured goods from the United States into Japan + Manufacturing sales of United States affiliates in Japan).

[c] Suppressed to avoid disclosure of data of individual companies.

[d] Excludes transport equipment.

[e] Excludes foods and kindred products from affiliates' sales in manufacturing and exports and imports of foodstuffs from trade statistics, as the data of foodstuffs in trade statistics cannot be broken down into manufactured and non-manufactured foodstuffs.

[3] Although in both countries investment of more than 10 per cent equity share is considered as FDI, there are large differences in figures reported by Japan's Ministry of Finance and by the United States Department of Commerce. This is partly due to the following. Compared to the United States FDI data, Japanese FDI data, both inward and outward, are based on approval/notification, which are normally higher than FDI that is actually made, and do not include disinvestments (thus, not net investment). In flow terms, approved/notified outward FDI is 1.6 times as large as FDI in a balance of payments during the last decade (1979-1988). Furthermore, Japanese outward FDI data do not take reinvested earnings into account. Regarding Japanese inward FDI data, although reinvested earnings (only by companies whose foreign equity here is more than 50 per cent) are included in total FDI, they are not available for each investing country and thus these figures are not reflected in table 1. Although loan investment has been included only in flows since 1985, it is not included in inward stock. Japanese data on FDI are discussed in Hiroki Sakamoto, "Japan's outward and inward FDI", *The CTC Reporter*, No. 27 (Spring 1989), pp. 64-68. For United States data, see Betty Barker, "United States: data on foreign direct investment", *The CTC Reporter*, No. 18 (Autumn 1984), pp. 52-56.

[3] The ratio of reinvested earnings to total inflows of Japan into the United States during the period 1983-1987 was 13.1 per cent. United States Department of Commerce, "Foreign direct investment in the United States: detail for position and balance of payments flows", *Survey of Current Business*, various issues.

[4] The ratio of reinvested earnings to total outflows of the United States into Japan during the period 1983-1987 was 98.8 per cent. United States Department of Commerce, "U. S. direct investment abroad: detail for position and balance of payments flows", *Survey of Current Business*, various issues.

Table 4. Selected data for Japanese affiliates in the United States and United States affiliates in Japan, reported by MITI

Industry	Number of affiliates	Total assets	Sales	Net income	Number of employees (Thousands)
			(Millions of dollars)		
Japanese affiliates in the United States, fiscal year 1985[a]					
Primary[b]	25	..	2 145	–39	1.6
Share in all Japanese affiliates abroad	13.4	..	28.2	(216)[c]	2.0
Manufacturing	339	..	21 502	–311	106.0
Share in all Japanese affiliates abroad	15.1	..	38.8	(–197)[c]	13.2
Services[d]	826	..	116 659	562	56.1
Share in all Japanese affiliates abroad	28.3	..	52.9	56.0	31.1
All industries[d]	1 190	..	140 306	212	163.6
Share in all Japanese affiliates abroad	22.3	..	49.5	20.7	15.5
United States affiliates in Japan, fiscal year 1984[a]					
Manufacturing	242	14 996	23 609	689	79.2
Share in all foreign affiliates in Japan	59.2	62.3	59.5	82.3	75.9
Services[e]	192	3 299	9 960	115	16.7
Share in all foreign affiliates in Japan	39.6	65.2	70.2	73.8	69.0
All industries	434	18 295	33 568	804	95.9
Share in all foreign affiliates in Japan	48.5	62.8	62.3	80.9	74.6
Memo: Petroleum	10	8 855	19 900	246	9.8
Share in all foreign affiliates in Japan	66.7	67.5	64.5	87.6	74.3

Sources: Ministry of International Trade and Industry (MITI), *Wagakuni Kigyo no Kaigai Jigyo Katsudo (Japanese Firms' Business Activities Abroad)*, the 16th Survey (Tokyo, Keibun Shuppan, April 1988) and *Gaishi-kei Kigyo no Doko (Trends of Foreign Affiliates)*, the 19th Survey (Tokyo, Keibun Shuppan, September 1987).

[a] Reported Japanese data is based only on companies that responded to the questionnaire sent by MITI. Thus, figures are underestimated. All data are converted to dollars by using the foreign exchange rate at the end of the fiscal year.

[b] Agriculture, forestry and fishing, and mining.

[c] Absolute value of all Japanese affiliates abroad.

[d] Excludes banks, insurance and other financial companies.

[e] Includes primary industry.

Differences in sectoral distribution between Japanese FDI in the United States and United States FDI in Japan indicate the relative importance of FDI in different sectors, and suggest that Japanese and United States TNCs have different corporate strategies. The primary corporate objective of Japanese TNCs in the international market is to expand their market share. Thus, FDI in commerce, undertaken to facilitate exports from the home country and distribute Japanese products more efficiently in host countries, is quite substantial. On the other hand, United States TNCs tend to concentrate their FDI in sectors where the potential for current profits is high. Rates of return on United States FDI are highest in manufacturing. Thus, the share of manufacturing in total FDI is greater than for other sectors. This is particularly so in developed host countries. Reflecting those differences, the data show a concentration of Japanese FDI in the United States in wholesale trade and United States FDI in Japan in manufacturing (table 2).

Either two thirds (Japanese data [5]), or more than 80 per cent (table 2, United States data), of Japanese FDI in the United States are in services. Recent increases in Japanese FDI in banking, finance and real estate have been notable, resulting partly from financial liberalization in Japan and partly from a surplus of funds in Japanese financial institution. The overall importance of Japanese FDI in services in the United States, however, has been fairly constant. The largest increases in the share of Japanese FDI in the United States is in manufacturing, from 20 per cent in fiscal 1976 to 26 per cent in fiscal 1986 in stock terms, and that level corresponds to 13 per cent and 33 per cent, respectively, of the share of total Japanese manufacturing FDI stock in the world. [6]

Activities of TNCs

The evidence indicates that Japanese manufacturing companies still largely rely on exports for their foreign expansion. Just slightly more than 10 per cent of Japanese sales in the United States are by affiliates of TNCs, while about 80 per cent of United States manufactured products in Japan are produced by United States affiliates in Japan (table 3). However, though probably

[5] Ministry of Finance, *Zaisei Kinyu Tokei Geppo (Monetary and Financial Statistics Monthly Report)*, No. 428 (December 1987).

[6] *Idem.*, and earlier issues.

statistically insignificant during the periods examined, there is evidence that the Japanese penetration into United States markets by local sales is increasing, and that United States penetration into Japanese markets by exports is also increasing (table 3). It is very likely that data incorporating the effects of dramatic increases in Japanese FDI in the United States during 1986-1988, which will be available in the late 1980s or the early 1990s, would show the share of sales of Japanese affiliates in total Japanese sales in the United States to have grown substantially.

In 1986, the sale of Japanese manufactured goods in the United States, amounting to about $91 billion, was $20 billion more than that of United States manufactured goods in Japan. A decade earlier they were balanced at about $20 billion.[7]

[7] Foods and kindred products are excluded in this calculation. See footnote [d] of table 3.

However, if only affiliates' sales are singled out, which is a better way to measure transnationality, United States manufacturing affiliates in Japan have produced more than Japanese manufacturing affiliates in the United States (tables 4 and 5). If affiliates' sales in all industries are considered, the situation is completely the opposite, reflecting the greater concentration of Japanese FDI in services and yielding more Japanese affiliates' sales than United States affiliates' sales (tables 4 and 5).

About half of the sales of Japanese affiliates abroad are registered in the United States, which hosts approximately 1,000 Japanese affiliates (table 4). Japanese affiliates' sales are about one quarter of all foreign affiliates in the United States (table 5). In terms of sales, Japanese affiliates are the largest among foreign affiliates in the United States, but they rank behind United Kingdom and Canadian affiliates in terms of assets. On the other hand, United States TNCs locate only 4 per cent of their foreign affiliates in Japan. However, United States affiliates in Japan are, by far, the largest among foreign affiliates in terms of number, sales, assets, profits or employment (table 4). About 10 per cent of foreign sales and foreign assets of United States TNCs are accounted for by their affiliates located in Japan (table 5).

The net income of Japanese affiliates in manufacturing in the United States was negative in fiscal 1985 (Japanese data) and in 1986 (United States data) (tables 4 and 5). This may partly reflect Japanese corporate strategy to expand the market share of Japanese products by accepting low margins. More importantly, however, low income in the 1980s is the result of the fact that most Japanese manufacturing FDI in the United States is young (as of fiscal 1986 more than three quarters of Japanese manufacturing FDI stock in the United States was accumulated during the period 1981-1986) and, therefore, Japanese manufacturing affiliates have not grown enough to yield substantial profits. That

(continued on page 42)

Table 5. Selected data for Japanese affiliates in the United States and United States affiliates in Japan, reported by the Department of Commerce, 1986

Industry	Number of affiliates	Total assets	Sales	Net income	Employee compensation	Number of employees (Thousands)
			(Millions of dollars)			
Japanese affiliates in the United States						
Primary[a]	..	768	2 381	–6	45	2.1
Share in all foreign affiliates in the United States	..	0.8	3.2	(–1 567)[b]	0.7	1.3
Manufacturing	..	11 099	11 622	–348	2 362	67.5
Share in all foreign affiliates in the United States	..	5.8	6.2	(253)[b]	5.1	4.8
Services	..	83 749	149 010	473	4 331	146.3
Share in all foreign affiliates in the United States	..	15.3	36.8	12.1	12.7	10.4
All industries	943	96 704	165 740	102	6 755	216.4
Share in all foreign affiliates in the United States	9.3	1.7	24.8	3.9	7.8	7.3
United States affiliates in Japan						
Primary	..	15 814	22 836	1 168	697	14.8
Share in all United States affiliates abroad	..	8.1	11.0	12 8	6.0	3.6
Manufacturing	..	42 757	58 399	1 343	7 330	270.8
Share in all United States affiliates abroad	..	12.0	13.0	6.5	9.6	6.1
Services	..	21.727	16 941	699	2 060	58.1
Shares in all United States affiliates abroad	..	5.7	6.2	3.7	7.0	4.0
All industries	675	80 298	98 176	3 211	10 086	343.7
Shares in all United States affiliates abroad	4.0	8.6	10.5	6.6	8.6	5.5

Sources: United States Department of Commerce, *Foreign Direct Investment in the United States: Operations of U.S. Affiliates of Foreign Companies, Preliminary 1986 Estimates* (Washington, D.C., June 1988) and *U.S. Foreign Investment Abroad: Operations of U.S. Parent Companies and their Foreign Affiliates, Preliminary 1986 Estimates* (Washington, D.C., June 1988).

[a] Petroleum, agriculture, forestry and fishing, and mining.

[b] Absolute value of all foreign affiliates in the United States.

Transnational corporations in Europe 1992: Implications for developing countries

By Michelle Gittelman, UNCTC

The current programme of the European Community to complete the integration of its regional market by 1992 has attracted the keen interest of countries in both the developed and developing worlds, which anticipate possible benefits as well as potential threats from further European integration. Should the programme succeed as planned, then it is likely that the European Community will emerge in the 1990s as one of the world's most dynamic, technically sophisticated regional economies, with the prospect of strong growth in demand for the world's goods and services. At the same time, countries outside the region are wary of the possibility that they may be denied full access to the benefits of the integration effort, either because they may be at a disadvantage in crowded European markets or because the Community may elect to implement policies which would ensure that Community members, rather than third countries, would reap the most rewards from the 1992 programme.

Uncertainty about the 1992 programme has pushed foreign investment and regional economic integration issues to the top of the policy agenda of many countries. Developing countries, in particular, are hastening to achieve progress in their own regional integration programmes, to be prepared for a world increasingly characterized by large, regional groupings, with competition shifting rapidly from a national to a global dimension.

This article examines the impact of Europe 1992 on the activities of TNCs, with particular attention to the implications for developing countries. Regional economic integration in North America is also examined (see box).[1] A key concern is whether the process of economic integration between two or more countries attracts new inflows of foreign investment into those countries and, if so, whether the increased FDI is in addition to or at the expense of investment in other countries. That question is of crucial importance to developing countries: if investment is indeed "pulled" into an integrated region at the expense of other countries, or if trade and investment are allowed to flow freely within the regional markets of Europe and North America but not between them, developing countries risk the possibility of declining levels of already scarce, much needed foreign direct investment.

Overview of the 1992 programme

Although tariffs and quotas within the European Community have been largely eliminated, the regional economy has remained fragmented owing to the persistence of high non-tariff barriers: the European Commission has estimated that non-tariff barriers currently impose costs on Community industry of between $136 billion and $207 billion, roughly 5 per cent of the European Community's total GDP.[2] The most significant barriers are closed public procurement markets, differing technical, health and safety standards and customs formalities at frontier posts. In many manufacturing industries, non-tariff barriers greatly reduce the potential for intra-regional trade and investment. In the service sector, differing regulatory régimes in industries such as banking and transportation often block cross-border market entry altogether.

The 1992 programme is an attempt to realize the third and ultimate goal of the 1957 Treaty of Rome: the creation of a single, integrated, internal market free of restrictions on the movement of goods, services, capital and persons. Impetus for the programme, which did not get fully under way until the late 1980s, was in part motivated by the fact that many firms in the Community have progressively lost ground to their American and Japanese competitors, not only in extra-regional markets, but in the Community itself. This is particularly true for high-technology industries. In semiconductors, for instance, considered a strategic industry, American and Japanese companies dominate the European market with 44 per cent and 17 per cent 1988 market share, respectively.[3] In the automobile industry, it has been projected that Japanese car-makers will double their current market share to 20 per cent within the next six years.[4] Micro-electronics, electrical equipment, office automation and information technology are examples of industries in which European Community firms—including large TNCs—have failed to keep pace with competition from the United States and Japan, both in terms of market share and ability to innovate.

The 1992 programme is intended to address those issues; it is hoped that the cost savings from regional harmonization, coupled with the opening up of national markets (including markets for corporate assets) to more intraregional competition, as well as co-operation, will improve the competitive position of Europe, particularly in high-growth, technologically-advanced businesses such as micro-electronics and telecommunications.

In the latter half of the 1980s, the prospect of a unified Community market unleashed an unprecedented wave of business activity, as companies restructured

[1] For a longer treatment of the subject, see *Economic Integration and TNCs in the 1990s: Europe, North America and Developing Countries*, UNCTC Current Studies Series A, No. 15 (forthcoming), from which this article was excerpted.

[2] "The economics of 1992", *European Economy*, 35 (March, 1988).

[3] "Europe girds for invasion by the Japanese", *Wall Street Journal* (3 February 1989).

[4] The Economist Intelligence Unit, *The Passenger Car Market of Western Europe: Developments and Prospects* (London, 1989)

to position themselves for 1992. Surveys indicate that, by 1988, most companies assumed a single market in their strategic plans. This activity in the corporate sector, as well as rapid decision-making by the Commission and the European Council, has given the programme a momentum and success rate far beyond expectations; by September 1989, over half of the 279 directives of the 1992 programme had been adopted by the Council.

Several effects are expected to follow from market unification, the most important of which is a rise in the standard of living in the European Community. Recent studies forecast that 1992 might add from 2.5 per cent to 19.5 per cent to the Community's GDP in the medium term.[5] Those gains are expected to result from the static effects of removing costly barriers to trade as well as from the dynamic effects of an integrated industrial base. For instance, a recent study published by the European Commission estimates that the *direct* cost savings to car manufacturers from harmonization of technical standards (such as those relating to the colour of headlamps, for instance) will be about $1.85 billion, with another $2.18 billion saved through the dynamic gains of reorganization and rationalization of production, marketing and distribution networks.[6]

On a sectoral level, it is expected that the removal of non-tariff barriers will have the greatest structural impact on those industries which face highly segmented markets owing to closed public procurement markets and/or different national technical standards. Notable examples are telecommunications, pharmaceuticals, automobiles, defence electronics, processed foods and data processing.[7] Removing protective barriers around these industries is likely to lead to major changes in their structure and performance. Instead of a set of protected "national champions" which often dominate their home-country markets, restructuring and strategic alliances *across national borders* are expected to lead to the creation of large European groups active in the entire Community, with some becoming increasingly competitive in global markets as well. Those changes in the pattern of ownership, location and organization of European industry are already taking shape, as companies implement strategies to prepare themselves for the post-1992 environment.

Table 1. Cross-border mergers and acquisitions in the European Community (Number and value, 1988 and 1989)

	Number of deals		*Millions of dollars*		*Percentage increase 1988-1989*	
	1988[a]	*1989*[b]	*1988*[a]	*1989*[b]	*Number*	*Value*
Total	753	1 190	31 417	32 769	58	4
By asset size of deal						
Over $100 million	63	73	25 404	24 105	16	–5
Under $100 million	690	1 117	6 013	8 754	62	46
By country of purchaser						
European Community (EC)*	453	754	11 089	16 993	66	53
EC as percentage of total	35	50	17	24		
United States	121	192	6 435	8 700	59	35
EC as percentage of total	26	46	69	48	–	–
Japan	11	30	2 280	3 009	173	32
EC as percentage of total	14	23	21	31		
Switzerland	49	62	6 845	743	27	–89
EC as percentage of total	54	56	77	23		
Sweden	39	62	1 052	750	59	–29
EC as percentage of total	48	53	49	41		
Rest of world	67	76	2 665	2 464	13	–8
EC as percentage of total	31	33	22	18		
* *Major purchasers in the European Community*						
United Kingdom	245	315	4 411	5 190	29	18
EC as percentage of total	28	38	10	12		
France	70	180	3 772	6 788	157	80
EC as percentage of total	49	64	34	42		
Germany, Federal Republic of	37	71	405	1 344	92	232
EC as percentage of total	37	58	15	55		

Source: KPMG Dealwatch (March and December 1989).

[a] 12 months ended 31 December 1988.

[b] 12 months ended 30 September 1989.

Impact of 1992 on corporate restructuring and FDI flows

The scope of restructuring. Mergers and acquisitions data indicate that a great deal of corporate restructuring to prepare for 1992 is taking place on a regional and international scale, rather than within individual Community countries. Among *all* companies in the Community, 20 per cent of deals in 1988 were cross-border transactions, and the remaining 80 per cent were deals between two firms of the same nationality.[8] (A cross-border deal is defined as one in which a firm from the European Community is acquired by or merged with a firm from either another Community country or from a third country, such as Sweden or the United States.) However, among the largest 1,000 firms in the Community, cross-border deals made up over 40 per cent of the total transactions, a 10 per cent jump from the previous year.[9] The data indicate that, while the greatest *number* of mergers and acquisitions are domestic, in terms of *value*, a large and growing proportion of corporate assets in Europe are being traded across, rather than within, national borders.

An analysis of recent cross-border data indicates that, by late 1989, a great deal of cross-border restructuring to prepare for the single market had already taken place, even though at that time the deadline to achieve a single market was in theory still three years away (and in practice probably farther away). Table 1 shows that, in 1989, there was a 4 per cent *decline* in the value of large cross-border deals in the Community; in contrast, small and medium-size deals exhibited remarkable growth, increasing by 46 per cent and 62 per cent in terms of

[5] See Paolo Cecchini *et al.*, *The European Challenge, 1992: The Benefits of a Single Community* (Gower Publishing Co., Brookfield, Vermont, 1988); "The economics of 1992", *op. cit.*; Richard Baldwin, "The growth effects of 1992", *Economic Policy*, 9 (November 1989).

[6] "Auto industry opportunities and benefits forecast to be generated by the single European market" (Brussels, European Commission, 1988).

[7] For a complete discussion of the specific impact of 1992 on 40 sectors in the Community, see Pierre Buigues and Fabienne Ilzkovitz, "The sectoral impact of the internal market" (II/335/88-EN) (Brussels, Commission of the European Communities, 1989).

[8] 1988 data first three quarters only, from *The European Deal Review*, First six months 1989.

[9] Commission estimates in "Europe's buyout bulge", *The New York Times* (5 November 1989).

value and number of deals, respectively. That discrepancy implies two possible developments, which are independent but not mutually exclusive. It appears that *large TNCs have already implemented a substantial amount of restructuring in anticipation of 1992* and that now most cross-border restructuring is occurring among smaller firms, which are likely to be first-time foreign investors. Second, if it is true that the current wave of restructuring is now taking place in the small and medium-size business sector, then this is likely to result in the *consolidation of the Community's manufacturing and service industries across national boundaries*, as small and medium-size firms implement offensive and defensive regional expansion strategies.

Major players. In 1988 and 1989, North American TNCs appeared to be maintaining their levels of investments in *existing* European affiliates (illustrated by their capital expenditure plans), while the value of investments in *new* ventures (represented by mergers and acquisitions and flow data) decreased in relative terms (see tables 1 and 2). Contrasting this, Community firms and Japanese investors appeared to be actively searching for new foreign investments in the Community, with the proportion of cross-border deals located in the EC increasing strongly, both in terms of value and number (see table 1). Unlike the early days of the Common Market, when United States TNCs were the most active foreign investors in Western Europe, in the current phase of European integration the Europeans themselves, along with Japanese TNCs, appear to be the more aggressive foreign investors. It is likely that these differences in FDI patterns by American, European and Japanese TNCs are due to differences in their current competitive positions in the European market. These issues are further examined below.

Strategic responses of TNCs

The creation of a barrier-free market envisioned in the 1992 programme means that the scope of competition in the European Community will shift rapidly from a national to a regional dimension. This implies that a company which is currently strong in its home market may need to establish strong positions in *several* Community countries in order to survive in the barrier-free market. At the same time, the unification programme promises to increase the profitability of regionally-oriented firms, by simultaneously lowering their costs while expanding the size of the available market. Those firms which do not take advantage of these opportunities by implementing cross-border strategies thus risk being squeezed out by other firms that do.

TNCs are now implementing foreign-direct-investment strategies in response to those changes. Strategy options are determined by a company's current position in the regional market, which, in turn, tends to be a function of the company's ownership. Thus, a pattern is emerging from the various corporate strategies now being implemented in the European Community in which the key variables are the ownership of the firm, the length of time it has been an investor in the region, the industry to which it belongs, and its competitive position not only in the Community, but in global markets.

Table 2. United States foreign direct investment in the European Community, 1984-1990

(Billions of dollars)

	1984	1985	1986	1987	1988	1989[a]	1990[a]
Stock	69.5	81.2	98.6	120.1	126.5	..	..
EC as percentage of total	33.0	35.0	38.0	39.0	39.0	..	..
Outflows	-0.1	11.8	12.8	18.9	4.4	..	..
EC as percentage of total	–	66.0	49.0	43.0	25.0	..	..
EC-based affiliates' capital expenditures[b]	13.2	14.1	14.2	16.1	19.8	22.1	23.0
EC as percentage of total	39.0	40.0	44.0	47.0	46.0	45.0	46.0

Source: Survey of Current Business (June and August 1989).

[a] Most recent plans.

[b] Capital expenditures are for majority-owned EC affiliates of non-bank United States parents. Capital expenditures include all capital charges made to acquire, add to or improve property, plant and equipment.

United States TNCs. Most major United States TNCs have long-established positions in the Community, with experience in producing and marketing in Europe since the early days of the Common Market. Ford, for example, established an integrated European research and production network in the late 1960s which is superior to that of the major European car companies. IBM, which has been operating in Europe for over 75 years, is the industry leader in the European data-processing market, with a rationalized organization that includes 12 manufacturing plants, 9 research and development facilities, 7 scientific centres, and local sales and support offices.[10]

The strong direct presence of United States TNCs in Europe is illustrated by the fact that about 85 per cent of the market for American goods and services in the European Community is accounted for by the affiliates of United States TNCs which are located there (exports from the United States make up the remaining 15 per cent).[11] This means that United States TNCs have little reason to pursue *defensive export substituting* (trade-replacing) FDI strategies. With $428 billion in assets and 2 million employees already in Europe, United States TNCs are more likely to pursue reorganization investment strategies—involving a realignment of, rather than an increase in, existing investments—to position themselves in the single market.[12] In addition, since the Community market is expected to be one of the world's most dynamic in the next few years, several United States TNCs may increase the net level of investment in the Community as part of *offensive* investment strategies, to gain early footholds in fast-growing market segments. For instance, Coca-Cola, which has an 80 per cent share of the European cola market, is simultaneously pursuing reorganization and offensive investment strategies for its European Community subsidiaries. It is rationalizing its purchasing operations from four sources to one, reorganizing its distribution networks from a national to a regional orientation, restructuring management to create a single European Community division, and investing more than $100 million in new European plants.[13] As long-term foreign investors in Europe, many United States TNCs are probably better positioned right now for the single market than their European competitors in terms of organizational structure and degree of country and product specialization.

Japanese TNCs. The story is quite different for Japanese companies since Japan has a trade-based rather than an investment-based commercial relationship with the Community, with affiliates of Japanese TNCs accounting for less than 20 per cent of total sales of Japanese goods in Europe; the remaining 80 per cent are made up of exports from Japan.[14] This is behind the remarkable growth of new Japanese ventures

[10] *1992 Now*, IBM Europe (October 1989).

[11] United States Department of Commerce, *Survey of Current Business*, various issues.

[12] Figures include all of Europe. "US multinational companies: operations in 1987", United States Department of Commerce, *Survey of Current Business*, vol. 69, No. 6 (1988).

[13] "Soft drinks get the hard sell in Europe", *Wall Street Journal* (21 November 1988).

[14] Ministry of International Trade and Industry, *Wagakuni Kigyono Kaigai Jigyo Katsudo* (Tokyo, April 1988); Statistics Bureau, *Monthly Statistics of Japan* (Tokyo, April 1988).

in the Community during the past few years, as Japanese TNCs implement *defensive export-substituting investment* strategies, in part to protect themselves against possible barriers to Japanese exports. Although three quarters of the $35 billion FDI stock of Japanese firms in the Community in 1989 are in the service sector (of which two thirds is in banking), investment has been particularly strong in technology industries, with cumulative investment in the latter growing by nearly 50 per cent a year in the last five years, from $644 million in 1983 to $2,213 million in 1988.[15]

Japanese investors are locating not only more production in the Community, but also more research and engineering facilities there as well, reflecting the growing importance of the Community not just as a market, but as a global research and production centre. Sony, which first invested in the EC in 1974, now has eight assembly plants and two development and engineering centres in six EC countries.[16] Nissan is the first independent Japanese car company to locate all of its value-adding functions, including design and engineering, in the Community, and it has set a new precedent by announcing that it may export cars from Europe back to Japan.[17] Since many Japanese TNCs invest in the Community as if it were a single market from the outset, and since many have strong global brand positions and excellent managerial and technical assets, the European affiliates of Japanese TNCs are in a strong position to compete in the post-1992 environment, and to translate their successes in the single market into global markets in North America and the Pacific Rim.

European TNCs. Firms in the European Community are responding to a different set of challenges. While most have established affiliates in other Community countries, few have integrated their regional operations to the extent of American and Japanese firms. Furthermore, European TNCs tend to be more diversified than their American and Japanese competitors and are therefore likely to be at a cost disadvantage in a unified market. Thus, the strategies currently being pursued by European Community TNCs tend to focus on *de-diversification*, so as to specialize in their core business in the regional market, as well as *reorganization*, to integrate disparate European affiliates. Philips, one of Europe's largest TNCs in the electronics industry, was organized as a collection of autonomous national subsidiaries; it has recently restructured to create an integrated set of Europe-wide, product-based companies. Siemens faces a rapidly-changing competitive environment in which its sheltered position in the Federal Republic of Germany as a highly diversified "national champion" is no longer assured. To prepare for the single market, it launched a radical corporate reorganization in 1987, with plans to concentrate on high-growth segments of its core electronics/electrical business while expanding geographically in the Community through a series of acquisitions. Other firms operating in industries that are slated for rapid structural change as a result of 1992, such as Deutsche Bank (Federal Republic of Germany) in financial services and BSN (France) in food processing, are pursuing *offensive investment strategies* in anticipation of the opening of new product and geographical market segments.

In implementing their European strategies, TNCs are increasingly employing cross-border strategic alliances rather than engaging in mergers and acquisitions, since the former allow them to enter a new market far more rapidly than the latter; the intense competition for corporate assets in Europe has made speed, rather than certainty, a top priority. Furthermore, uncertainty about the direction of competition policy in the Community places a high premium on organizational flexibility, at least until Europe-wide competition rules are put in place.

Implications of 1992 for FDI in developing countries

From a developing country perspective, the principal FDI implications of Europe 1992 are trade-related, and pose a series of challenges. On the one hand, unification may be used to throw up barriers to goods originating from low-wage countries, and thus depress current and future export-oriented foreign investment located in those countries. On the other hand, rising demand, output and investment expected to result from the unification of the European economy should benefit its economic partners, among which developing countries count as some of the most important. In 1986, the European Community imported $US 135.6 billion from developing countries and exported $US 133.9 billion to them, about 40 per cent of the Community's total trade flows (table 3). At this early stage, the single European market can be seen as exerting both negative and positive effects on developing countries, with the net result depending largely on Commission policies and the behaviour of TNCs in response to those policies.

Negative implications

If the EC implements policies designed to promote European sourcing, then export-oriented FDI in developing countries could decline, as TNCs respond by exporting less to the Community and investing more within it. For example, investments by TNCs in developing countries for the production of components and/or goods which are destined for final assembly and sale in the European Community (such as semiconductors, automotive parts and consumer appliances) may be shifted to a Community location, even though developing countries might be more suitable locations for such investments. While this may have a negative effect on the total flows of FDI to developing countries, selected developing countries in the Mediterranean region (which enjoy trade preferences with the EC) and those benefiting from the Lomé Convention could see their position strengthened as host countries for FDI if they are seen as offering low-cost "gateways" to the European market (although some of the comparative advantages enjoyed by those countries have been chipped away by the inclusion of Greece, Portugal and Spain in the EC).

Positive implications

Contrasting such a scenario, FDI flows into developing countries could rise sharply if the borders around the single market are kept open to imports of components and final goods from non-EC countries. The 1992 programme has injected a strong dose of competition into many sectors of the European economy, so that achieving a low-cost position is likely to become a strategic imperative for many TNCs competing in growing Community markets. That fact, coupled with liberal commercial policies, could lead to rising FDI in developing countries, as part of a manufacturing strategy by TNCs to rationalize production among low-cost export bases in industries such as automobiles, office equipment, micro-electronics and consumer goods. In addition, the expected strengthening of the competitive position of European TNCs *vis-à-vis* their American and Japanese counterparts, coupled with the growing international orientation of European industry, could also lead to new investment flows by those firms into developing countries. Resource-based as well as manufacturing FDI in developing countries may also rise, if overall demand in the Community rises significantly.

The implications of Eastern Europe. Such a positive scenario, however, has recently been clouded by political events in Eastern European countries, some of which are formidable competitors with developing countries for foreign direct investment. Although those countries accounted for only 7 per cent of the Community's total imports and 5.5 per cent of its exports, current trends indicate that the trade and investment relationship between Eastern and Western Europe is poised for rapid growth. Several countries in Eastern Europe, such as the German Democratic Republic and Czechoslovakia, offer foreign investors a

[15] Japanese Ministry of Finance. The four industries included are electronics/electrical; general machinery; cars, trucks and transport; and pharmaceuticals and chemicals.

[16] "The emergence of a global company", *Financial Times* of London (2 October 1988).

[17] "A new wave of transplants", *Financial Times* of London (2 February 1990).

Table 3. European Community: product and geographical structure of trade, 1986

(Millions of U.S. dollars)

	Industrialized countries					Developing countries/territories							State trading countries b	World total
	United States	Japan	EFTA	Other	TOTAL	Latin America, total	Latin America, non-OPEC	Asian NICs a	Africa	OPEC	Other	Total		
Exports														
Agriculture	1 959	448	2 636	578	5 621	320	298	209	394	966	843	2 710	1 260	9 591
Percentage of world total	20	5	27	6	59	3	3	2	4	10	9	28	13	100
Percentage of country total	3	4	3	2	3	2	2	2	3	3	1	2	7	3
Energy	3 507	339	4 423	821	9 090	275	255	115	302	700	3 123	4 495	288	13 873
Percentage of world total	25	2	32	6	66	2	2	1	2	5	23	32	2	100
Percentage of country total	5	3	5	3	5	2	2	1	2	2	5	3	2	4
Manufactures	65 026	10 068	75 420	24 166	174 680	15 889	13 689	11 018	14 066	33 010	48 988	120 771	17 260	312 711
Percentage of world total	21	3	24	8	56	5	4	4	4	11	16	39	6	100
Percentage of country total	92	92	91	94	92	96	96	97	95	95	84	90	91	91
Adjustment	427	48	506	215	1 196	102	92	67	109	203	5 443	5 914	223	7 333
Total	70 919	10 903	82 985	25 780	190 587	16 586	14 334	11 409	14 871	34 879	58 397	133 890	19 031	343 508
Percentage of world total	21	3	24	8	55	5	4	3	4	10	17	39	6	100
Imports														
Agriculture	4 826	135	1 579	3 181	9 721	7 376	7 138	843	5 758	1 238	4 475	19 452	1 264	30 437
Percentage of world total	16	0	5	10	32	24	23	3	19	4	15	64	4	100
Percentage of country total	9	0	2	16	5	34	36	6	38	3	9	14	6	9
Energy	3 388	28	7 422	1 957	12 795	3 076	1 975	20	2 482	33 827	8 589	46 893	10 323	70 011
Percentage of world total	5	0	11	3	18	4	3	0	4	48	12	67	15	100
Percentage of country total	6	0	10	10	7	14	10	0	16	88	18	35	45	21
Manufactures	46 074	33 543	62 262	14 826	156 705	10 929	10 634	14 004	6 809	3 258	28 837	63 542	11 171	231 418
Percentage of world total	20	14	27	6	68	5	5	6	3	1	12	27	5	100
Percentage of country total	84	99	87	74	87	51	54	94	45	8	61	47	49	68
Adjustment	443	28	190	50	711	56	53	72	62	26	5 544	5 757	43	6 511
Total	54 731	33 734	71 453	20 014	179 932	21 437	19 800	14 939	15 111	38 349	47 445	135 644	22 801	338 377
Percentage of world total	16	10	21	6	53	6	6	4	4	11	14	40	7	100

Source: *International Trade of the European Community, European Economy*, No. 39 (Brussels, Commission of the European Communities, March 1989), pp. 89-99.

a Hong Kong, Malaysia, Philippines, Republic of Korea, Singapore, Taiwan Province of China.

b Albania, Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Mongolia, Poland, Romania, USSR.

low-cost, highly skilled labour force and a basic industrial infrastructure, as well as close proximity to the dynamic market in the neighbouring European Community. As part of their strategic plans for the single market, many TNCs are actively looking at investment opportunities in the newly-opened Eastern European economies, with a view to exporting low-market goods and services back to Western Europe. Examples include Volkswagen's plan to build a factory in the German Democratic Republic (which enjoys duty-free access to the Federal Republic of Germany), to produce inexpensive cars for export to Western markets, and General Electric's recent investment of $150 million in a factory in Hungary as part of its strategic plan for 1992.[18]

Should those early investments prove sound in the next few years, more are sure to follow, and the competition facing developing countries for foreign capital will intensify. A quote by the chairperson of Saint-Gobain, one of France's largest TNCs, is instructive in this regard: "Everyone is talking about the business opportunities in South-East Asia. What luck to have the same opportunities suddenly open on our doorstep".[19] If the economies of Eastern Europe remain open to FDI, and should they be granted some form of duty-free access to Community markets, then it is likely that they will displace some developing countries as attractive locations for direct investment by TNCs, both as export bases and as domestic markets to which to sell.

The record to date: Community policies and TNC responses

Community policies. It is too early to predict with certainty how 1992 will affect FDI in developing countries. The single market programme hasn't been implemented yet, and numerous factors—such as world macro-economic conditions and integration in other regions such as North America or the Pacific Rim—are likely to have a profound effect on the direction of Community policies and the global activities of TNCs. Currently, each of the 12 Community members maintains its own external commercial policies, ranging from very liberal to highly restrictive, depending on the country and the industry concerned; one of the aims of the 1992 programme is to harmonize those diverse sets of rules into a Community-wide régime. Particular areas of concern on the 1992 agenda—those items which may, depending on how they are implemented, put developing countries at a disadvantage—include local-content requirements, rules of origin, and harmonized tariffs and quotas. The policy path which the European Community decides to follow in those areas will in large part determine whether Europe 1992 means more or less FDI in developing countries.

Local-content requirements set the percentage of value added that must be performed within the Community in order for a good to qualify for duty-free treatment. Rules of origin establish the criteria used to determine the country from which a product originates, so that if it is determined to have originated outside the Community,

[18] "Good chance for East German economic reform", *Financial Times* (17 November 1989); "General Electric plans attack from the East" (20 November 1989); "Venture planned by GE in Hungary", *New York Times* (16 November 1989).

[19] Quote by Jean Louis Beffa, "The shape of Europe to come", *Business Week* (27 November 1989).

United States-Canada Free Trade Agreement

Overview of the Agreement

The United States-Canada Free Trade Agreement, which became effective on 1 January 1989, is notable as the first trade agreement explicitly to liberalize FDI and trade in services between its signatories. FDI will be affected by the Agreement in two ways: through new rules on investment, described below, and through the removal of tariffs and non-tariff barriers to trade, as TNCs—which account for about 70 per cent of merchandise trade flows between the two countries—revise their cross-border investment strategies in response to free trade.

The Agreement liberalizes foreign direct investment in a number of ways, the most important of which is the establishment of the principle of national treatment between the United States and Canada, so that while each country's national policies regarding investment will remain in effect, the other party's firms will be granted equal treatment with domestic firms with respect to the establishment, acquisition and operations of a business. In addition, neither Government will be allowed to impose performance requirements on firms from the other country in the areas of export performance, local content and minimum equity participation (although investment requirements are still allowed to be negotiated in the areas of research and development, technology transfer, product mandates and employment). Furthermore, the Agreement raises the asset threshhold level at which Canada will review any new acquisitions by American firms from $5 million to $150 million, and Canada has waived the right to review indirect American acquisitions (purchases of firms that were previously foreign-owned).

The principle of national treatment has been extended to include 64 commercial services. Trade in services is further liberalized by facilitating the border crossing of personnel and by the stipulation that neither country may require service firms of the other to establish a local business in order to provide a service, if doing so violates the national treatment principle.

The Agreement, while broad in scope, does not represent a major shift in Canada-United States economic relations: already about 70 per cent of bilateral trade is duty-free. The Canadian acquisition review process has not represented a significant barrier to FDI by the United States in Canada in recent years. Furthermore, both countries are allowed to maintain their respective domestic regulatory policies, although some of Canada's industrial support policies are under review to determine if they violate free-trade principles.

The provisions covering services serve to institutionalize rather than establish for the first time free trade in services, which are already traded relatively freely between the two countries. The real significance of the agreement in services lies in the fact that it may set a precedent for future multilateral trade negotiations.

Canadian manufacturing industries that are likely to be most affected by the Agreement following the removal of trade barriers include petrochemicals, metal alloys, clothing and several resource-based products, all of which faced high or escalating tariffs in the United States. United States companies will primarily benefit from national treatment and larger public procurement markets, particularly in advertising and other commercial services.

Impact on TNCs

FDI plays a key role in the trade flows between the two countries, and thus any agreement which influences their trading relationship is also an investment policy instrument. In fact, FDI plays a larger role than bilateral trade in the commercial relationship between the two countries. In 1987, the value of goods and services sold between the two countries as a result of FDI exceeded the value of bilateral trade by 69 per cent. Canada is the largest single host country of United States FDI, the stock of which totalled $61 billion in 1988, about 70 per cent of total FDI stock in Canada. Canadian FDI stock in the United States totalled $27 billion in 1988. Though still large, the gap between the two countries' investment positions has been steadily narrowing since 1975.[1]

Capital expenditure plans by United States TNCs indicate that the Free Trade Agreement caused United States manufacturers to step up investments in their Canadian affiliates.

In the case of Canadian FDI in the United States, it is expected that the Free Trade Agreement will have a net effect of slowing down its rate of growth, which has averaged 20 per cent a year over the period from 1977 to 1987. Studies have shown that a major motive for Canadian TNCs to invest in the United States has been market access in the face of rising United States protectionism.[2] In so far as the Free Trade Agreement assures such access, there is likely to be a decline in the rate of growth of Canadian FDI in the United States.

Perhaps the most significant long-term impact of the Free Trade Agreement on FDI will be to increase investment by third countries in the integrated North American market, particularly in Canada. While the Canadian market is small (population 26 million) many large regional markets in the United States can be profitably served from a Canadian base, given Canada's abundant natural resources, cheap energy, geographical proximity, excellent infrastructure and relatively inexpensive labour. Just as Japanese car manufacturers have chosen to locate production in Tennessee because of its central location and low labour costs, so will TNCs increase investment in Canada, now that they are assured of duty-free access to the United States market. The Hyundai Motor Company of the Republic of Korea, for instance, assembles cars in Canada for sale in the entire North American market. Concerning Japanese investment, it accounted for only 3 per cent of total FDI stock in Canada in 1988, but its 1980-1988 annual growth rate averaged over 22 per cent, the highest of any country.[3]

Free trade between the United States and Canada appears to have triggered a wave of restructuring of Canadian industry, as companies retreat from activities that are likely to prove unsustainable in a free-trade environment, and enter businesses that are slated for growth. The total value of mergers and acquisitions in the first half of 1989 (estimated at $Can 20 billion) was nearly as high as the value for the previous 12 months ($Can 24 billion). Non-Canadian companies have been estimated to account for about one third of all deals in the past few years.[4]

Notable examples of strategic moves by TNCs in response to the Free Trade Agreement include Procter & Gamble's decision to

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[1] *Survey of Current Business*, vol. 69 (June and July 1989). *Direction of Trade Statistics Year Book* (Washington, D.C., 1988).

[2] Alan Rugman, "Trade liberalization and international investment", *Discussion paper No. 347*, Economic and Social Council of Canada (Ottawa, 1988).

[3] *Financial Times* of London, "M & A activity in hyper-drive" (9 November 1989).

[4] *Ibid.*

integrate its four Canadian plants into its existing United States operations, as part of a plan to "forget about the border".[5] As a result of the Free Trade Agreement, both Du Pont and Dow Chemical are increasing investments in their Canadian export-oriented operations. Where TNCs relied on tariff and non-tariff barriers to remain competitive, divestment has been the response to free trade. Gillette has closed down its razor- and pen-making facilities in Canada, and Whirlpool and Burlington also plan to cut back on Canadian production, preferring to export to Canada from United States plants.

Implications for developing countries

The Free Trade Agreement is likely to have the greatest impact on FDI in developing countries in the automobile sector. Several developing countries have established important links with North American TNCs, supplying them with parts and/or assembled vehicles (Canada imported nearly $Can 1 billion of automotive parts from developing countries in 1987, 80 per cent of which were shipped from Mexico and Brazil).[6] Although the Free Trade Agreement leaves intact the Auto Pact, which liberalized United States-Canadian automotive trade in 1965, it raises the effective local-content requirement for duty-free treatment from 50 to 70 per cent. By raising the local-content requirement, the Agreement not only encourages third-party car-makers to invest directly in rather than export to North America, but it also means that any new investment in the North American car industry is likely to incorporate fewer developing-country inputs than if there had been no Agreement. In fact, Hyundai, which currently incorporates only about 25 per cent Canadian local content in its Canadian-made cars, plans to double that amount to meet the Agreement's requirements for tariff-free treatment.[7]

That trend, however, is not expected to affect the operations of Ford, General Motors and Chrysler, which already surpass the Agreement's local-content requirement, and could, in fact, increase their sourcing from developing countries without violating the terms of the Agreement. Those companies account for about 45 per cent of the shipment of car parts in North America.

Regarding the general implications for developing countries, only goods and services originating in Canada or the United States can qualify for duty-free treatment between the two countries. As defined by the Agreement's rules of origin, in order to qualify, products and services must undergo either substantial transformation in North America or incorporate at least 50 per cent North American value added (in some cases, both conditions must be met).

Because of those stringent rules of origin, selected goods exported to North America from developing countries may suffer a price disadvantage *vis-à-vis* the same goods produced in North America, if the former face a tariff while the latter do not. In addition, no developing country receives the guaranteed market access to the United States as does Canada, giving the latter a formidable competitive advantage as an export base for TNCs. However, existing United States duty-free arrangements with developing countries and regions, such as 806/807 and the generalized system of preferences (GSP), will remain in place.

As a result of the Free Trade Agreement, some developing-country firms are shifting from exporting to FDI in North America. For instance, in September 1989, the Gerdau group of Brazil purchased a Canadian steel mill for $52 million, thereby accessing state-of-the-art steel-making technology while bypassing United States quotas on Brazilian steel.[8] Such investment by developing countries' TNCs is likely to increase as a result of the Free Trade Agreement, particularly in natural resources processing and engineering industries, in an effort to avoid tariff and non-tariff barriers imposed on imports from outside the integrated North American market.

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[5] Louis Kraar, "North America's new trade punch", *Fortune* (22 May 1989).

[6] Douglas Arthur, "The impact of the Canada-United States Free Trade Agreement on Pacific Rim industries", *Pacific Basin Economic Council*, Canadian Committee and the Department of External Affairs (13 February 1989).

[7] "Hyundai in Canada: Springboard for a wider assault", Special section, *South Korea: Finance and Industry*, *Financial Times* of London (27 November 1989).

[8] "Brazilians leap the barriers", *South* (December 1989).

quotas or tariffs could be imposed if necessary. Both policies are geared towards influencing the sourcing activities of TNCs which operate within the barrier-free market. Depending on how the rules are set, FDI in developing countries could be either discouraged or unaffected. For example, Community-wide local content and rules of origin could be set such that a car that was assembled in the United Kingdom from Japanese and Malaysian parts and shipped to France could have to submit to Community quotas or tariffs on imported automobiles, rather than enter France duty- and quota-free as a British car. Depending on the level of external tariffs on car imports, such treatment could induce the TNC to shift its Malaysian (and Japanese) operations directly to a Community location.

Recent decisions made by the Community and individual members in these policy areas indicate that it may take a hard line in certain sensitive product markets, although it is not clear whether Community-wide external tariffs and quotas will be established and, if so, whether they will be onerous, a key issue in assessing the FDI implications of local-content requirements and rules of origin. Some countries in the Community have indicated that they will not consider the output of "screwdriver plants" to be of European origin (these are the EC affiliates of non-EC TNCs, which assemble or process imports) unless they meet a very high level of Community value added. A recent case was significant in that it attached a specific *qualitative* aspect to the rules of origin: integrated circuits manufactured partly in the EC by a non-EC supplier were treated as imports because the most *technology-intensive* portion of production (diffusion) had not been performed within the Community. High local-content requirements imply increased value added located within the Community and less in third countries (and hence less in developing countries); attaching qualitative criteria to those requirements implies that not only a lesser *amount* of value added, but less *technology-intensive* value added, would be located in developing countries.

Responses by TNCs: developed countries. It is likely that some FDI in developing countries has *already* been affected by those early developments. For instance Intel, the world's largest manufacturer of computer chips, recently invested about $400 million in a facility in Ireland, a decision directly motivated by the above-mentioned diffusion regulation.[20] In another example, the head of Sony in Europe, speaking about his company's plan to invest several hundred million dollars in Europe, has said: "If we followed just the economics of manufacturing, we'd ship the lot from South-East Asia".[21] Even though the fears of European TNC executives that the Community might place restrictions on imported goods and components could be largely imaginary at this stage, and be proved wrong in the future, the above actions by TNCs represent a real opportunity lost to developing countries in the form of declining foreign direct investment.

TNCs from developing countries. These fears have not been limited to developed-

[20] "Intel to set up chip plant in Ireland", *Financial Times* (4 October 1989).

[21] Quote by Jack Schmuckli, chairman of Sony Eurona, "The emergence of a global company", *Financial Times* (2 October 1989).

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(continued)

country TNCs: TNCs from several developing countries have begun to invest in the Community, whether through joint ventures or greenfield investments. In many cases, such investments are made to ensure market access after 1992. But they also serve other important strategic objectives. In some cases, they establish a position in fast-growing Community markets where the developing country firm has a comparative advantage. Others are geared towards accessing the state-of-the-art technologies that are likely to emerge in the Community, which in recent years has witnessed the launching of several collaborative research consortia and ambitious R & D projects, partly in anticipation of growth in high-technology markets after 1992.

It is mainly those developing countries which have an adequate technology base and industrial infrastructure that have become foreign investors in the European Community. Brazil, for example, is now the fourth largest investor in the Portuguese economy, with joint ventures and recent acquisitions in industries such as construction, textiles, and shoes. In India, several companies are planning links with firms in the European Community, particularly in the engineering sector. Companies from Taiwan Province of China and the Republic of Korea are actively planning for joint ventures and mergers with European companies. Governments from those and other developing countries are looking for ways to facilitate such investments. At the same time, they are attempting to attract new investments from the dynamic European economy, and hastening their own regional integration efforts, to ensure that they will be in a position to share the economic benefits which are sure to be created by the 1992 single-market programme. □

FDI between Japan and the U.S.
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(continued from page 34)

trend is likely to continue if manufacturing FDI flows into the United States at the current rate. On the other hand, United States manufacturing affiliates in Japan perform very well, even better than Japanese companies.[8] Higher net income in host countries is made possible only after production and marketing schemes are well established.

Impacts on host countries

According to the United States Department of Commerce, Japanese affiliates in the United States employed 216,000 people and sold $166 billion worth of goods and services in 1986, while United States affiliates in Japan employed 344,000 and had sales of $98 billion (table 5). Reflecting the large number employed in United States affiliates in Japan, the importance of affiliates in the host-country economy in terms of employment is higher for the United States affiliates in Japan than Japanese affiliates in the United States. United States affiliates in Japan account for about 1 per cent of total employment in all companies in Japan, while Japanese affiliates in the United States account for 0.5 per cent of total employment in the United States.[9] In terms of sales, the importance of affiliates in the respective host countries is almost equal: 2 to 3 per cent of total sales of all companies in each host country is accounted for by those affiliates. If only manufacturing is considered, United States affiliates in Japan are more prominent than Japanese affiliates in the United States. For both affiliates, however, those figures are still considerably small in the total economic activities of these host countries.

About 13 per cent of sales were exported by both sets of affiliates. In the United States, the level of Japanese affiliates' exports were about one half of the total exports of all foreign affiliates and 6 per cent of all United States exports of goods and services in 1986.[10] Imports of Japanese affiliates accounted for half of the total imports of all foreign affiliates and 13 per cent of all United States imports of goods and services. The net effect was an increase in the United States balance of payments deficit of $41 billion in 1986.

In 1986, employment in United States affiliates in Japan was 128,000 more than that in Japanese affiliates in the United States. However, the number of people employed by United States affiliates in Japan decreased by about 50,000 from the level in 1977. On the other hand, during the same period, employment in Japanese affiliates in the United States increased by 140,000. Furthermore, Japanese affiliates probably created more employment opportunities than any other foreign affiliates in the United States. That is because the bulk of new plants established (95 out of 164 in 1987) and of plant expansion (43 out of 67) in the United States by foreign investors are by Japanese TNCs.[11] That mode of investment—greenfield investment—creates more new employment opportunities than other types of FDI. □

[8] For example, the ratio of net income to sales indicates 2.9 per cent for United States manufacturing affiliates, 1.1 per cent for European manufacturing affiliates and 1.6 per cent for all Japanese manufacturing companies in fiscal 1984. See Ministry of International Trade and Industry, *Gaishi-kei Kigyo no Doko (Trends of Foreign Affiliates)*, the 19th Survey (Tokyo, Keibun Shuppan, September 1987).

[9] The data source in this paragraph is the same as in tables 4 and 5 and Ministry of Finance, *Zaisei Kinyu Tokei Geppo (Monetary and Financial Statistics Monthly Report)*, various issues, and United States Department of Commerce, *Survey of Current Business*, various issues.

[10] The data source in this paragraph is the same as in tables 3 and 5.

[11] United States Department of Commerce, *Foreign Direct Investment in the United States: 1987 Transactions* (Washington, D.C., December 1988), table VI, pp. 30-31.

Intellectual property rights and investment issues in the Uruguay Round

By I. K. Minta, UNCTC

Trade-related aspects of intellectual property rights (TRIPS) and trade-related investment measures (TRIMs), have been under intensive discussion in the Uruguay Round of GATT negotiations since 1986. Although those negotiations are primarily concerned with trade issues, an important dimension of TRIPS and TRIMs is their role in global (and national) investment and technology flows and in the promotion of economic development. This article examines this dimension of TRIPS and TRIMs, and is based on the Centre's report to the sixteenth session of the Commission on these subjects (E/C.10/1990/13).

Technology and world competition

The Uruguay Round negotiations have sought to establish multilateral standards for the protection and enforcement of intellectual property rights as well as for government regulation of foreign investment and services (among 15 subject areas). This has been largely at the initiative of the leading industrialized countries and TNCs, which have an overriding interest in the establishment of optimum conditions for the global commercialization of technology through trade and investment. Those interests have, in turn, been intensified by increasing competitive pressures in the world economy.

The most dramatic evidence of the changing global competitive patterns has been the large trade deficits of the United States throughout the past decade, the competitive strength of Japanese TNCs, the increasing ascendancy of the newly industrialized countries in international trade, and the emergence of the United States as a leading host country (in addition to being the leading home country) for FDI. The advent of full economic integration in the European Community at the end of 1992 has added new pressures to these changing competitive patterns. The rapid technological advances of the past two decades—particularly in microelectronics and computer technology—have played a dominant role in those trends and have made technological innovation the cutting edge of global competitive advantage.

While the Uruguay Round of Multilateral Trade Negotiations are still pending, it may be inappropriate to engage in detailed analysis of the negotiating proposals. But, beyond the GATT focus on trade liberalization, policies in this area would need to take account of empirical evidence on the impact of intellectual property protection on foreign investment and technology flows, and on the impact of trade-related investment measures on the behaviour of investors, as well as on economic development.

The TRIPS negotiations

TNCs attach great importance to the TRIPS issue inasmuch as it pertains to the legal protection of their technological assets and to the economic space for the commercialization of those assets. That concern is reflected in negotiating proposals presented by the leading industrialized countries, which seek to establish new substantive standards for the protection of intellectual property on a global basis, and enforcement measures (internal and at the border) for the control of trade in counterfeit products.

It is also echoed by recent statements (reported in the financial press) by senior officials of the Governments of the Republic of Korea and Mexico, for example, who concede that their intellectual property régimes operate as disincentives to investment and technology flows, and have undertaken to strengthen the levels of protection provided. These seem to be partly the result of actions under section 301 of the United States Trade and Tariff Act and bilateral discussions with the United States.[1]

The TRIPS negotiations were apparently triggered by an increasing incidence of piracy and trade in counterfeit products. Estimates of trade losses from counterfeiting and piracy, according to industry groups in the industrialized countries, range up to about $60 billion annually, with corresponding losses in employment etc.

Developing countries, on their part, have generally argued that the levels of intellectual property protection, and the conditions attached to such protection, should be left largely to the discretion of each country—as is currently the case under prevailing international instruments—in order to allow full consideration of different national socio-economic conditions and development needs in the formulation of relevant laws and policies. They have argued, further, that the control of counterfeiting should be a function of specific national laws and should not itself impede legitimate trade.

TRIPS and foreign investment

Intellectual property protection becomes relevant to investment and transfer of technology issues in at least two respects: first, legal protection of technology is considered necessary for its utilization in investment, licensing and transfer of technology arrangements; second, compulsory licensing of protected technology is considered a necessary policy option by many developed and developing countries in situations where such technology is not utilized for local production, or for other public policy reasons.

On the question of impact, one can hypothesize that increased levels of intellectual property protection would lead to increased innovative and economic activity, including increased trade, foreign direct investment and technology flows. It stands to reason that the legal protection of intellec-

[1] Section 301 of the United States Trade and Tariff Act, 1984, as amended, provides, *inter alia*, for the creation of "watch lists" of countries whose intellectual property protection policies adversely affect United States trading interests.

tual property would provide the necessary incentive for the investment of resources in technological innovation, and the legal security for the utilization of technology in production, investments and trade, with broader socio-economic benefits for the larger community.

It should, therefore, follow that inadequate levels of intellectual property protection would operate as a disincentive to investment and technology flows. For example, an OECD study states that the lack of software protection and important differences in the enforcement of national laws protecting software, where they exist, represent a major disincentive to FDI.[2] An UNCTAD study on transfer of technology also points out that investment in and the diffusion of new technologies, namely, computer programmes, integrated circuits and biotechnological inventions, hinges to a large extent upon the type of protection they are granted.[3] Another OECD survey named limited or unsatisfactory protection of industrial property rights as the third most important disincentive associated with licensing in developing countries, after foreign exchange controls and government regulations on transfer of technology agreements.[4] Overall, high-technology enterprises have been concerned about inadequate legal protection of semiconductor component masks, computer software and computer-related technology—areas in which legal protection is a relatively recent phenomenon and is still in a state of flux in the OECD countries, which have set the tone in those (as in most other) areas.

But the role of intellectual property protection in investment flows would seem to be much more complex than the above would suggest. To begin with, the literature on investment determinants hardly considered intellectual property protection among the major factors influencing the investment decision, perhaps in much the same way that technology was not considered among the classical factors of production, namely, land, labour and capital. It should be noted, though, that the increasing attention being paid to intellectual property in recent years would tend to suggest otherwise.

But, in contrast to the evidence on the disincentive effect of inadequate intellectual property protection, a recent case study on the Turkish pharmaceutical industry showed that the abolition of product patents for pharmaceuticals in that country in 1961 did not adversely affect inflows of technology or FDI in that industry. Indeed, such inflows increased at a much faster rate in that industry compared to other sectors in which patent protection was provided. This showed that "no simple causal link can be made between patents and foreign investment".[5]

It is also significant to note that the abolition of patents on pharmaceuticals had no adverse impact on technology licensing arrangements or on the introduction of new drugs:

> "Of the 1,319 commercially available drugs in 1982 which were introduced between 1954 and 1982 and for which historical data was available, 270 products (20.5 per cent) were introduced between 1954 and 1961 [when there was patent protection], and 1,049 (79.5 per cent) were introduced from 1962 onwards. Moreover, 80.2 per cent of all the products introduced following the abolition of patents have been produced by the locally-owned firms either through licensing contracts or, in many cases, through access to non-patented sources of technology. In sum, it is evident from the above findings that licensing agreements did not depend in a systematic way on whether or not there was patent protection in the country."[6]

A recent case study on Nigeria confirmed familiar assertions on the role of patents in developing countries, namely, the overwhelming dominance of TNCs in patent ownership, the low incidence of local working of patents through investment or transfer of technology arrangements, their predominant use to cover imports and to eliminate or control competition, and the prevalence of restrictive business practices in licensing agreements. The study found the lowest patent exploitation rates in the

[2] OECD, *Internationalization of Software and Computer Services* (Paris, 1989), p. 85.

[3] UNCTAD, "Periodic report, 1986" (TD/B/C.6/133, 24 July 1986).

[4] OECD, "International technology licensing: survey results" (Paris, 1987) mimeo.

[5] Arman Kirim, "Reconsidering patents and economic development: a case study of the Turkish pharmaceutical industry", *World Development*, 13 (1985), p. 227.

[6] *Ibid.*, p. 228.

The FIRA Panel case

One recent case between the United States and Canada illustrates the treatment of TRIMs through the dispute settlement procedures of the General Agreement on Tariffs and Trade. In the FIRA Panel case, the United States had questioned the use of local purchasing and manufacturing requirements under Canada's Foreign Investment Review Act (1973) as being trade-distortive and inconsistent with the national treatment standard and other GATT provisions. It was also argued that export requirements under that law constituted unwarranted governmental interference in commercial operations and raised questions of dumping of products abroad, as well as of the "nullification and impairment" of previous trade commitments. In response, Canada denied any such effects, and argued, *inter alia*, that the law left it to investors to make specific undertakings in the investment-screening process and that, while such undertakings were legally enforceable, they were not specifically imposed by the law.

In its decision, the FIRA Panel found that "undertakings to purchase goods of Canadian origin...exclude the possibility of purchasing available imported products so that the latter are clearly treated less favourably than domestic products".[a] This constituted discrimination in favour of domestic products in violation of the GATT national treatment standard (article III.4). The Panel found the element of choice on the part of investors in making such undertakings to be irrelevant so long as there was governmental involvement in the preferential treatment of domestic products. However, the Panel did not find the export requirements to be inconsistent with Canada's GATT obligations. It also considered the local manufacturing requirements to be outside its terms of reference, which had mentioned only the two other requirements.

But one particular decision of special importance to developing countries was the Panel's statement (in response to arguments made by Argentina as an interested party in the case) that, "in disputes involving less-developed contracting parties full account should be taken of the special provisions in the General Agreement relating to these countries (such as article XVIII:C)".[b] As has become well-established under GATT, developing countries are allowed greater flexibility in the use of trade-restrictive measures for a variety of reasons, including balance-of-payments problems and infant industry and development considerations.

[a] GATT, "Canada—administration of the Foreign Investment Review Act (Report of the Panel adopted on 7 February 1984)", *BISD, 30th Supplement* (Geneva, March 1984), p. 159. That law was replaced by the Investment Act of 1985.

[b] *Ibid.*, p. 158.

most technologically intensive and dynamic industries—such as in pharmaceuticals (4 per cent), chemicals (5 per cent) and machinery and tools (1 per cent)—while higher exploitation rates (5 to 10 per cent) were found with respect to older technologies, such as in food products, cosmetics and textiles.[7] This suggests that, even where patent protection is provided, foreign investors may tend to exploit older or more mature rather than newer technologies in developing countries. The factors influencing such investment patterns would probably have little to do with levels of intellectual property protection.

It is ironic to note, moreover, that low levels of intellectual property protection were often used in the past, in developed countries, to promote emerging industries (by precluding or minimizing the monopolization of markets by intellectual property holders) or to develop local competitive capacity. Thus, for periods of up to a century or more, many European countries made patent protection conditional on local working or manufacture on penalty of forfeiture or compulsory licensing, and most still maintain compulsory-licensing provisions in their industrial property laws. The United States, on its part, only abolished the "manufacturing clause" in its copyright law as recently as 1986. That provision prohibited copyright protection for works not manufactured in the United States.

It is also paradoxical that the newly-industrialized countries—which have attracted most controversy for their inadequate levels of intellectual property protection—have nevertheless been receiving more foreign direct investments than most other developing countries.

Trade-related investment measures

The notion of a distortion of trade patterns has been the main rationale for the negotiation of multilateral standards to control the use of trade-related investment measures (TRIMs). Such distortion is deemed to occur when business decisions are made on the basis of considerations other than market forces. Besides host-country investment measures, it would seem that all measures directed at foreign investors or affiliates, including corporate and home-country measures, could be regarded as TRIMs to the extent that they may have distortive effects on trade and investment patterns.

The table lists four categories of measures which could be characterized as TRIMs, namely, incentives, performance requirements, corporate measures and home-country measures, and their possible impact on trade and investment flows.

Table. Trade-related investment measures and their possible impact on trade and investment

Measure	*Possible economic impact*
Investment incentives	Influence location of investments
Tax concessions	
Tariff concessions	
Subsidies	
Investment grants	
Performance requirements	
Local equity requirements	Restrict ownership of investments
Licensing requirements	Require technology transfer
Remittance restrictions	Restrict external financial transfers
Foreign exchange restrictions	Restrict external financial transfers
Manufacturing limitations	Restrict production
Transfer of technology requirements	Require technology transfer
Domestic sales requirements	Displace imports
Manufacturing requirements	Displace imports
Product mandating requirements	Displace other exports
Trade balancing requirements	Displace other exports
Local content requirements	Displace imports
Export requirements	Displace other exports
Import substitution requirements	Displace imports
Corporate measures (restrictive business practices)	
Market allocation	Restrict exports
Collusive tendering	Excessive pricing for imports
Refusal to deal	Restricts exports/imports
Exclusive dealing	Export prohibition
Tied sales	Displace other imports/exports
Resale price maintenance	Excessive pricing for imports
Price fixing	Excessive pricing
Differential pricing	Excessive pricing
Transfer pricing	Excessive pricing for imports; low pricing for exports
Home-country measures	
Export limitation on foreign affiliates	Restricts trade
Preferential taxes for income on investments	Subsidize investments

Source: UNCTC, based on negotiating proposals at the Uruguay Round and other material.

There are two main schools of thought on the propriety of investment incentives and performance requirements. The arguments in favour regard them as legitimate policy instruments that enable Governments to influence the behaviour of investors along desired patterns, as well as to counteract the negative effects of market forces. With investment incentives, host countries attempt to deal with structural imbalances in their economies by giving special advantages to investments in particular sectors or locations. Performance requirements are also used to foster the integration of foreign affiliates into the national economy, to enhance their contributions to development objectives and to minimize perceived negative effects of global corporate strategies, such as intra-group transfers of income to profit centres outside the host country and corporate restrictions on transfer of technology and on the trading patterns of affiliates or licensees.[8]

The arguments against TRIMs regard them as market-interventionist and economically harmful. It is argued that host countries, both developed and developing (but more frequently developing countries), behave in an inconsistent manner by using various incentives to attract foreign investment and, at the same time, imposing performance requirements, which operate as disincentives to investment. The competition to attract foreign investment is also seen as forcing countries to offer more incentives than they otherwise would have,

[7] Owen Adikibi, "The multinational corporation and monopoly of patents in Nigeria", *World Development*, 16 (1988) p. 517.

[8] UNCTC, *Transnational Corporations in World Development: Trends and Prospects* (United Nations pubication, Sales No. E.88.II.A.7).

resulting in a degree of subsidization that nullifies or reduces gains from the investment. Above all, they are regarded as an unwarranted interference in the free operation of market forces and a distortion of the level and pattern of trade and investment flows, with negative consequences for the economic well-being of the countries concerned and for the efficient allocation of world resources.[9]

A comprehensive study on TRIMs, sponsored by the World Bank in the early 1980s, established that investment incentives influence the locational decisions of foreign investors in most cases. However, that study found the impact of performance requirements to be somewhat mixed: some did have an impact on the investment decision and on trade flows, while others did not.[10] A subsequent study, sponsored by the Overseas Private Investment Corporation of the United States, came to the following conclusions:[11]

- *First*, performance requirements are part of a much larger phenomenon, namely, the struggle of home and host countries to influence the location of production, the selection of inputs, the scale of operations and the marketing of output on the part of transnational corporations;
- *Second*, estimates of the extent to which performance requirements actually alter trade patterns, displace production or cost jobs tend to be overstated; such impact varies between industries, but the overall economic impact tends to be small;
- *Third*, the extent to which performance requirements cause economic distortions and inefficiencies is mixed. Some may be benign or even beneficial, correcting for other distortions or hastening the process of infant-industry development. Many others produce significant losses in economic welfare. In general, performance requirements are not a first-best policy instrument, but in a second-best world in which TNCs have substantial discretion about how and where to conduct their operations, they serve an important purpose in securing explicit commitments from companies taking advantage of investment incentives.

Conclusions

It is perhaps not surprising that, in this new technological age, a very high premium is placed on intellectual property protection as a determinant of foreign investment and technology flows. But it does not follow that intellectual property protection will always lead to investment and technology flows in all countries, industries or situations. Such flows would tend to be determined by different combinations of factors over and above the level of intellectual property protection—such as the investment climate of the particular country, the size of its market, the global investment strategies of the particular investors, the type of technology involved and the feasibility of protecting it by other means, and the country's scientific and industrial infrastructure. In addition, the host country's investment and transfer-of-technology policies, as well as corporate-investment strategies, are probably of greater importance than the level of intellectual property protection for the determination of investment and technology flows.

As with TRIPS, empirical evidence on the economic impact, costs and benefits of investment incentives and performance requirements is rather mixed. The TRIMs issue raises a fundamental question concerning the modes by which host countries, particularly developing countries, may pursue their development objectives, and the extent to which they can rely on market forces alone to attract foreign investments or to enhance the advantages derived from such investments. Despite the obvious merits of, and an increasing trend towards, market-oriented investment policies in many countries, it seems clear that some degree of regulatory measures in particular countries or situations may be necessary in order to safeguard important public-policy interests which may not always be resolved satisfactorily by market forces. That need may indeed not be restricted to developing countries, but may arise at least occasionally in developed countries as well.

[9] See, for example, Stephen E. Guisinger, *et al.*, *Investment Incentives and Performance Requirements* (New York, Praeger, 1985); Guisinger, "Investment incentives and performance requirements: they matter", *The CTC Reporter*, No. 20 (Autumn 1985), p. 38.

[10] Guisinger *et al.*, *op. cit.*

[11] Theodore Moran and Charles Pearson, *Trade-related Investment Performance Requirements* (OPIC, Washington, D.C., 1987); Moran and Pearson, "Tread carefully in the field of TRIP measures" *The World Economy*, 11 (1988), p. 119.

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(continued on page 60)

GNS negotiators participate in workshop on TNC activities in services

Transnational corporations play an important role in the delivery of services to foreign markets. Since a majority of services are not tradable in the traditional sense of product movement across borders, the role of TNCs in international transactions in services is inextricably linked to the production activities of TNCs through FDI and other forms of activities abroad.

Various aspects of the activities of TNCs in the services sector were discussed at an informal workshop organized by UNCTC at Montreux, Switzerland, on 11 and 12 November 1989 for developing-country negotiators in the group of negotiations on services of the Uruguay Round, mainly those posted at Geneva. Participants at the workshop also included some developed-country negotiators, and experts from academia and from the private sectors, as well as from international organizations. Recent work by the Centre on services, as well as a number of papers prepared specially for the workshop, provided the background for the discussions.

After a brief review of issues relating to services in the Uruguay Round negotiations and of trends and developments with respect to FDI in services and its impact and implications for host countries, the workshop focused on some conceptual and definitional issues relating to international transactions in services. Since most services require close contact between the producer and customer, many services transactions generally require cross-border movement of factors of production. One issue of special interest in that context is the question of where to draw the boundary line between international trade and FDI, or between cross-border transactions and transactions undertaken by affiliates of TNCs. Although clear-cut definitions of FDI applicable to both goods and services have been established by international organizations such as IMF and OECD, among others, there is no clear-cut or widely-accepted definition of trade in services. Thus, certain transactions may be classified differently by various people, and by data-gathering agencies, depending upon convention, purpose or convenience. The practical problems encountered in distinguishing between different types of transactions and interpreting available data may, moreover, differ from one service industry to another.

The role of TNCs in international transactions in services was a central theme of the workshop.

Issues relating to TNC activities in selected service industries, including some of the subsectors that have been the subject of recent discussions in the GNS—telecommunications, construction, tourism and professional business services—also came up for discussion at the workshop. International markets in all of those services are substantial and growing, although not necessarily at a steady pace. Major players are, for the most part, TNCs from the industrialized market economies. In some areas, however, such as construction and certain professional services, firms from developing countries are making their presence felt.

Discussions also centered on key concepts relating to the formulation of a multilateral framework for services.

As far as developing countries are concerned, major questions in the context of liberalizing international services transactions, relate to the economic impact of TNC operations, in terms of employment and the generation of income, exports and balance of payments, as well as to broader considerations, such as the strategic or public utility character of certain service industries.

Perhaps most importantly, countries are concerned about the effects on domestic service industries and their capabilities, especially through the transfer of technology. Because of the skill and knowledge content of services, such as professional and construction services and even tourism, the scope for technology transfer to host-country entities by TNCs seems to be considerable. Although data do not permit extensive generalization in that regard, some TNCs, especially in professional services, are observed to implement significant training programmes for their employees world-wide. In terms of technology transfer, however, as well as the overall impact, some developing countries question whether they can benefit in any significant way from TNC participation in services unless they develop their infrastructure and support services, and unless the value added in the host country is sufficiently high.

International frameworks and arrangements relating to FDI—the third focus of the workshop—incorporate a number of key concepts which have relevance for the ongoing negotiations on services. These relate to areas such as market access, standards of treatment, development promotion, transparency, technical co-operation, exceptions and safeguards, nationalization, remittances and corporate responsibility. In the area of market access, for example, access for services would generally involve access for services producers, and questions arise regarding entry and ownership of service establishments, as well as entry and residence of personnel or labour. Among the many issues involved in formulating a multilateral framework, the most important for developing countries is that of finding ways and means of integrating the objective of the development of developing countries into a framework for international trade in services. The draft United Nations Code of Conduct on TNCs provides an example of a framework in which the principle of development promotion is given effect, through special concern for the interests of developing countries in formulating the substance of the instrument, as well as through special rules and principles, provisions relating to transfer of technology and restrictive business practices, and technical co-operation. Various facets of those and other mechanisms and their relevance for the ongoing negotiations were discussed at the workshop, drawing upon ideas contained in workshop documents relating to the draft Code and a comprehensive paper on key concepts in international investment arrangements and their relevance to international transactions in services. □

TNCs in the United States before 1914*

By Mira Wilkins

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In the late 1980s, the United States became the greatest debtor nation in the world, that is, its obligations to foreign investors exceeded their obligations to Americans. Part of the United States obligations to other countries includes the investments by foreign businesses in the country. In its last survey, UNCTC noted the rising importance of the United States as a host to foreign direct investment (FDI).[1]

This is the second time in its history that the United States has had the status of the world's greatest debtor nation; the first time was before 1914. Table 1 reflects the 1914 position of the United States. At that time, foreign TNCs had sizeable interests in the country. During America's colonial period, all non-resident investment was direct investment. From independence (1776) to roughly 1875, the principal foreign investment in the United States went into public finance. States, cities and the Federal Government attracted the most foreign investment. Whether it was financing the American revolution, or the acquisition of additional territory (the Louisiana Purchase of 1803), or the financing of banks, canals or railroads, government debt provided a conduit for the entry of foreign capital.

From 1875 to 1914, however, America's federal, state and municipal securities were not of paramount interest to foreign investors (although New York City looked to London and Paris for its financial needs in the early part of the twentieth century). Rather, the private sector attracted the most foreign investment, much of which, like the investments in the public sector, was of a portfolio nature.[2] United States railroad managers used those portfolio investments on a large scale to finance their railroads, which were fundamental in the country's economic development; they opened up resources, made land settlement viable and, more importantly, in the process established the basis for a national market. The linkage effects were multiple. While there were some TNCs with direct investment in railroads (the Canadian railroad systems that spread into the United States, for example), foreign investors typically restricted their interest in the railways to financial support (and only intervened if there were defaults, or poor financial performance). American entrepreneurs and railroad managers took the initiative. Because Americans were able to tap European capital markets, capital shortages did not retard construction. Most students of United States economic history are aware of the large amounts of foreign savings employed in building the huge United States railroad network.

What is less familiar is the significant role of FDI in the United States economy, in sectors other than railroads. Direct investment from abroad began in the colonial era, and continued to increase in the nineteenth and early twentieth centuries. The direct investors brought in capital, technology and skills. Table 2 gives one set of estimates on FDI in the United States in 1914. Those figures suggest that FDI (excluding the direct investment in railroads) was a mere 17 per cent of the total, but today, when everyone is discussing FDI in the United States, the amount is estimated at roughly 20 per cent of foreign investment in the United States.[3]

The earliest direct investors were the colonizing companies, for example, the Virginia Company and the Dutch West India Company, which were in America seeking profits in the new world. Then came the merchants that had partnerships in America. English companies invested in the colonies in iron ore, mining and export, and repatriated the profits to investors in their home country. Some of those companies sent managers and skilled workers to the colonies, where they carefully monitored technological developments.

In 1776, after independence, there were additional direct investments from abroad. Often there was a "domestication" of foreign investment. For example, Du Pont was founded in 1801 by French capital, but very quickly became an American company. The headquarters crossed the Atlantic, the control migrated, the management moved to the United States and the obligations to foreigners dissipated and then disappeared. The foreign direct investment became American.

"Domestication" was an important reflection of the fact that, during the nine-

* Based on Mira Wilkins, *The History of Foreign Investment in the United States to 1914* (Cambridge, Massachusetts, Harvard University Press, 1989).

[1] *Transnational Corporations and World Development: Trends and Prospects* (United Nations publication, Sales No. E.88.II.A.7), chap. V. Except in the section on the colonial period, the author uses the word America as equivalent to the United States.

[2] Foreign portfolio investment is defined as investment in shares (where there was no control), in bonds and in long-term bank lending. FDI is defined as investment that is sufficient to carry control. TNCs make direct investments.

[3] United States House of Representatives, Committee on Foreign Affairs, Subcommittee on International Economic Policy and Trade, *Foreign Investment in the United States* (Washington, D.C., 1989), p. 1; and Robert P. Forrestal, "Perspective: foreign investment and protectionism", *Economic Update*, 2 (June 1989), p. 2.

teenth century, the United States was a country of immigrants. It is important that immigrant businesses that had no obligations to their home countries were *not* FDI. None the less, the presence of immigrants served to stimulate FDI in the United States for many reasons: immigrants often provided sources of information; they were engaged as trusted agents of foreign TNCs; they functioned as managers and employees in the United States for foreign companies; and they were customers for such companies (no re-education on the products was required).

Although United States TNCs have been thought of as innovators in modern transnational behaviour,[4] in the late nineteenth century it was the United Kingdom TNCs that dominated direct investment worldwide. In no other country were United Kingdom direct investments more in evidence than in the United States. At the turn of the century, J. & P. Coats, Ltd., a Scottish thread-maker, was Britain's largest company — it could be called the first modern TNC. Its history in the United States began with exports to that market; subsequently, it sent family members to represent the firm. Since 1839, when the first of these men established a marketing organization in America, Coats has maintained its presence in the country. In 1869, at the initiative of an American thread-maker, Coats invested in its first mill in the United States and, by the turn of the century, it was a multiplant company in the country. At that time, it had world-wide operations, comprising 17 production centres with over 21,000 employees.

Coats was not the only United Kingdom TNC with manufacturing facilities in the United States. Some 100 United Kingdom manufacturing companies had established close to 255 factories in the country before 1914. While some of those British companies were small, some were among the United Kingdom's largest enterprises. Although headquartered in the United Kingdom, some had plants only in the United States, while others, like Coats, had manufacturing facilities in many countries around the globe.

There were numerous British companies in sectors in the United States ranging from mining to mortgage-lending, from cattle-raising to providing accounting services. Some were in "high tech" industries (in the early 1900s, a British company dominated the new radio communications industry). Contrary to the popular view that TNCs in services are a recent phenomenon, United Kingdom TNCs in the United States produced both goods and services before the First World War.

Table 1. A balance sheet as of 1 July 1914

Principal lenders[a]		*Principal borrowers*[a]	
Country	*Level (Billions of United States dollars)*	*Country*	*Level (Billions of United States dollars)*
United Kingdom	18.0	United States	7.1
France	9.0	Russia	3.8
Germany	7.3	Canada	3.7
United States	3.5	Argentina	3.0
Netherlands	2.0	Austria-Hungary	2.5
Belgium	1.5	Spain	2.5
Switzerland	1.5	Brazil	2.2
		Mexico	2.0
		India and Ceylon	2.0
		South Africa	1.7
		Australia	1.7
		China	1.6
Other	2.2	Other[c]	11.2
Total	45.0	Total	45.0

Source: Mira Wilkins, *The History of Foreign Investment in the United States to 1914* (Cambridge, Massachusetts, Harvard University Press, 1989), p. 145. All figures are "gross".

[a] No country is itemized separately that had long-term foreign credits or debts of less than $1.5 billion.

[b] Japan and Russia (especially in China), Portugal (especially in Brazil), Sweden (especially in Russia), Canada (especially in the United States and the Caribbean), for example.

[c] Includes residual *not* separately itemized: $4.7 billion for the rest of Europe, including the Ottoman Empire, $2.3 billion for the rest of Asia; $1.8 billion for the rest of Latin America, including the Caribbean; $2.3 billion for all of Africa, except South Africa; and $0.1 billion for the rest of Oceania.

A number of points can be made about the British TNCs in the United States prior to 1914. First, they were in a wide range of industries, including textiles. It has often been assumed that the textile industry is not one that attracts FDI, yet there is ample evidence of overseas companies in this industry (not only British, but German, French, and Swiss firms as well). In each case, the products were, in contemporary terms, advanced ones (made using processes technologically superior to those used by competitors). Often, the products (such as thread) were protected by a trade mark. Frequently, the investors found a special market niche in which they were able to excel.

Second, while the specific reasons that British companies entered the United States varied, most came to take advantage of the opportunities in the country and most sold their output in America. Some came to mine the country's rich resources, while others raised cattle in the wide open American spaces. Yet,despite the fact that the United Kingdom was an importer of minerals and of meat, few of the many British mining companies and none of the cattle companies exported the products to Europe within their own organization (that is, they were not fully integrated enterprises). A major exception was in borax, where a British TNC was fully integrated. Another important exception was the brief investment by a British Rothschild company in the United States' leading copper mining company. In that case, the output was exported and sold through Rothschild-controlled channels. There were other internationally integrated enterprises, but the typical British-owned company in American primary product production in the late nineteenth and early twentieth centuries sold the output of its mine, agricultural property or cattle ranch within the United States.

Many of the British companies that had exported to America found that, because of tariffs, it was necessary to manufacture within the country to retain or increase their market position. After the Civil War, where there were high United States tariffs, Americans began producing goods that had previously been imported; this encouraged British direct investors that had sold exported goods in America to manufacture there. Still others invested because it was cheaper to make the product in the United States (because of the combination of lower raw material costs and heavy costs of shipping) than to export it from Britain. There were, however, foreign direct investors who entered the country simply to take advantage of the market opportunities and had had no prior experience with exports.

Third, many British-owned companies

[4] On their early history, see Mira Wilkins, *The Emergence of Multinational Enterprise: American Business Abroad from the Colonial Era to 1914* (Cambridge, Massachusetts, Harvard University Press, 1970).

were leaders in America in the sectors in which they operated: the foremost flour producer in America, Pillsbury, for example, was subject to a British take-over in 1889 (one has a sense of déjà vu, when reading about Pillsbury's recent return to British ownership). A major United States meat packer was purchased by a British company. By 1914, British-Dutch Shell was poised to become an important company in the United States oil industry. In none of these three cases were there exports to the United States first, followed by FDI. A number of British firms favoured acquisition as a form of market entry.

Fourth, many British direct investors did not survive for long in the American market. It was not the policy of the Government of the United States that was responsible for the brevity of their activities, but rather their inability to manage their operations from a distance. There were frequent failures. Thus, for example, of the 255 British-owned plants (none of which was an immigrant operation) before 1914, at least a third were no longer under British ownership by 1914.

Fifth, a key reason for the numerous exits was that, unlike typical American TNCs that developed at home first and then, using their experience at home, moved abroad, there were among the British investors in the United States a great number of firms that were "free-standing companies".[5] Those were headquartered in Britain, set up by a promoter (American or British), and designed to transfer the rich capital resources of the old world to the developing United States. Those companies made FDI, but they had no operating experience in their home market in the business that they were undertaking abroad, and thus had to hire outsiders. In the United States, since their only advantage was capital, they quickly found that they were not competitive and so they did not survive. While many British companies had problems managing their business in America, those free-standing companies (which had no home-operating experience to transfer to the United States) were at a particular disadvantage.

Sixth, the factor distinguishing some very successful British TNCs was technical know-how in addition to capital. An American enterprise had tried to produce rayon (the first synthetic textile) and had failed; British Courtaulds — with its technological expertise — entered and became an extraordinary success. And the major British accounting firms, after some initial difficulties, obtained large American accounts and became role models for subsequent American enterprises.

Seventh, whether successes or failures, British multinationals had an impact in America. Many FDI that did not persist left in their wake economic activity that would, in time, flourish under American ownership and control.

Eighth, the pre-1914 United Kingdom TNCs displayed a wide diversity in their forms of operations. There were new entries, take-overs, wholly-owned units and a variety of joint ventures, as well as licensing arrangements, management contracts, and so forth.

While the British were the most numerous of the foreign direct investors in pre-First World War America, they were by no means the only ones. Austro-Hungarian, Belgian, Dutch, French, German, Italian, Russian, Swedish, Swiss, and even Bulgarian TNCs were operating in the United States. There were two large Bulgarian insurance companies that did business in the United States as well as elsewhere abroad. Aside from European-headquarted TNCs, there were also Canadian and Japanese TNCs and a few from some other countries.

It is impossible in this short summary to provide details on the myriad of activities of the numerous TNCs that were in the United States from nations other than Great Britain. Some of the more outstanding examples are the following. Particular sectors of the American chemical industry were dominated by German TNCs. In the electrical field, the predecessor of General Electric was, for a brief period, a German direct investment in the United States. The Mercedes car was also manufactured in the United States by a German TNC before the First World War. Yet, the Germans never achieved the same significance in the American electrical and automobile industries that they did in chemicals, the reasons for which are set forth in detail in the author's book entitled *The History of Foreign Investment in the United States to 1914*.[6]

There were profitable Dutch mortgage banks that provided mortgage lending in the American west and south. The French multinational Michelin manufactured tires in the United States before 1914. The Swiss Nestlé, which is now very important in the American market, produced in America in the early part of the twentieth century. The Bank of Montreal was a pioneer Canadian bank in the United States (at one time it was the largest bank in Chicago). The Yokohama Specie Bank (the predecessor of the Bank of Tokyo) had representation in the United States as far back as the 1880s.

Just as in the case of the British TNCs, foreign direct investors of other nationalities were in many different industries and sectors. American commercial banks were not allowed to expand abroad before the passage of the Federal Reserve Act (in December 1913); thus, the large American national banks did not expand abroad. By contrast, Canadian banks had no restrictions on opening branches, domestically or internationally, and they very quickly crossed over the United States border. It can be said of all TNCs that, in order to survive, the firms had to have and had to retain some kind of advantage in the American market. The advantages might involve technological superiority, experience, and very often advertised products with a trade mark. Foreign TNCs might also find a market niche that, for one reason or another, had not attracted Americans. Thus, a German firm blended an advertised coffee-chicory product that it sold primarily to Germans who had immigrated to America (here we have a typical trade marked, niche market, product). Another German firm made a highly specialized, trademarked product, used in leather tanning.

Again, like the British TNCs, TNCs of other nationalities entered into business in the United States to take advantage of the opportunities. Some went to obtain America's rich resources—investing in mines, cattle ranches, and other such activities.

Table 2. Foreign investment in the United States, 1 July 1914
(Millions of United States dollars)

Railroads	4 170
Other securities	1 710
Direct investments (excluding railroads)	1 210
Total	7 090

Source: Cleona Lewis, *America's Stake in International Investments* (Washington, D.C., Brookings Institution, 1938), p. 546.

[5] On this phrase, see Mira Wilkins, "The free-standing company, 1870-1914, an important type of British foreign direct investment", *Economic History Review*, 2nd ser., 41 (May 1988), pp. 259-282.

[6] Wilkins, *The History of Foreign Investment in the United States to 1914* (Cambridge, Massachusetts, Harvard University Press, 1989).

Table 3. Foreign holders of United States patents

Year	*United States patents granted to citizens of foreign countries*					*Patents issued to United States citizens*	*Patents granted foreign citizens, as percentage of those granted*
	Total	*United Kingdom*	*Germany*	*Canada*	*France*		
1885	1 549	549	298	284	138	22 535	6.4
1890	2 105	721	452	371	178	24 103	8.0
1895	2 049	614	539	302	202	19 949	9.3
1900	3 483	987	1 070	367	341	22 935	13.2
1905	3 292	770	987	413	303	26 978	10.9
1910	3 719	894	1 083	534	315	32 059	10.3
1914	4 595	1 033	1 475	667	379	37 009	11.0

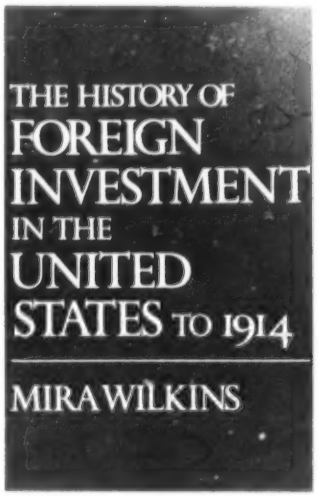
Source: Reports of the United States Commissioner of Patents.

As in the case of the British investors, few of those foreign investors in primary production had fully integrated activities (including handling the export of the output). An exception was the German-controlled American Metal Company, which had mines in Mexico (not in the United States, except some coal mines that were used to fuel one of its processing operations). It had many American investments in processing, and it entered into export activity (co-ordinated with its German parent) on a major scale. There were other German metal traders that were not integrated into mining, yet invested in processing and handled the trade. Many foreign multinationals invested in the United States in order to sell within the country. Some invested to provide customers for their European exports. Others invested because of high tariffs.

The reasons for investment by those TNCs in America were many, including the rise of United States competition. Tariffs were important in encouraging investments in manufacturing, but were not a reason for the raw material procurement investments, nor for the investments in mortgage-lending or insurance.

French multinationals in America were innovative in transforming the United States wool industry, introducing new technology in high-quality woollen products. German companies dominated in the high-technology magneto field, they were important in America's new electrochemical industry, and they led in pharmaceutical products. Swiss and German TNCs in silk-making ranked among the leaders in that new American industry, while Swedish companies were paramount in making equipment for dairies.

Just as British companies had difficulties surviving in the American market, many other foreign firms also encountered problems. Managing business in America from abroad proved far from simple. The American market was very special and hard to penetrate. While there were numerous British "free-standing" companies, that



form was less in evidence among other nationalities. There were, however, some Dutch and some French "free-standing" companies in America, some of which met the same obstacles as their British counterparts and were, for the same reasons, short-lived. European TNCs that had advantages (and many did have advantages), that were able to install good management and that found niche markets did very well indeed, and there were a number of highly successful European TNCs in the United States. Again, like the British firms, whether unsuccessful or successful, the entry of those firms contributed to American prosperity.

TNCs used a variety of forms as modes of entry into the United States. The Germans, in particular, often engaged in various types of licensing. Sometimes they licensed independent American firms; sometimes they obtained minority interests in American enterprises in exchange for the licence or for the sale of United States patents. Sometimes they licensed joint venture companies, and sometimes they licensed wholly-owned subsidiaries. The sale of patents and the licensing arrangements were highly complex, for patents were very instrumental in German penetration of American markets in the years before 1914. By 1914, Germans were the leaders among foreign citizens obtaining United States patents (table 3).

To conclude, before 1914 foreign investments in America were not solely of a portfolio nature. Numerous foreign TNCs from many countries were in the United States before the First World War in many sectors of the American economy. They started new enterprises and took over existing American ones. There is little evidence of cross-hauling. Transnational corporations in the United States tended to be in different industries from United States business abroad. Transnational corporations in this country contributed positively to United States economic development, introducing new products and processes, technology, and capital. Often they stimulated the emergence of United States businesses. Even when they were short-lived, they made contributions, leaving behind productive resources that could be employed by Americans to good advantage. Their impact on American economic development was significant. In the late nineteenth and early twentieth centuries, while the United States was the world's leading debtor nation, it became the world's greatest industrial country and its multinationals were already expanding world-wide. □

INFORMATION DISCLOSURE AND REPORTING

Reflections on the ISAR Group's seventh session: Accounting and reporting by TNCs

By ***Pieter A. Wessel***

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In March 1989, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (the ISAR Group), held its seventh session, the first after its mandate had been renewed for another three sessions in 1988 by the Commission on Transnational Corporations. The ISAR Group's report on this seventh session (E/C.10/1989/7) was approved by the Commission at its fifteenth session in April 1989. As usual, the report—together with the introductory documentation prepared by UNCTC acting as the Group's secretariat—will be issued in one volume in the near future as a United Nations publication in the series International Accounting and Reporting Issues.

The present article reflects some impressions of the seventh session and will therefore be somewhat more than purely descriptive and less than exhaustive. As a lawyer and registered accountant with over 40 years of experience in a top accounting firm, I presume to make some unusual but, I hope, constructive observations. Despite any critical comments, I have a profound regard for the work of the Group and the dedication of the experts who serve it. Although I attended most of the Group's sessions as the representative of the Netherlands, the views expressed are my own.

Introduction

For the reader who is not familiar with the United Nations involvement in the field of accounting and reporting by TNCs, it may be useful to recall briefly that, according to its mandate, as formulated in October 1982 by the United Nations Economic and Social Council, the Group should, *inter alia*, serve as an international body for the consideration of ways and means

- to improve the availability and comparability of information provided by TNCs in the field of accounting and reporting; and
- to identify further steps to be taken in pursuit of the long-term objective of the international harmonization of such information.

In my article on the ISAR Group's fifth session, in *The CTC Reporter*, No. 24 (Autumn 1987), I closely followed the structure of its programme of work, adopted as early as 1983, which is the implementation of the very essence of the Group's mandate. As that programme has constituted the substance of the agenda for each of the Group's sessions, that approach still seems to be appropriate also for the present article. The main components of the programme are as follows:

(a) Consideration of issues of accounting and reporting:
  (i) Specifically identified by the Group for discussion during the session;
  (ii) Arising out of the comprehensive information system developed and maintained by UNCTC;
  (iii) Arising out of the Code of Conduct on Transnational Corporations;

(b) Discussion of appropriate measures necessary to give effect to the work of the Group in the area of accounting and reporting falling within the scope of the work of the Commission;

(c) Discussion of the most appropriate means of bringing the work of the Group to the attention of Governments, TNCs and all other interested parties;

(d) Discussion of ways and means of developing education, research and practical training in the field of accounting and reporting in Member States, especially the developing countries;

(e) Discussion of any other appropriate business.

The consideration of issues of accounting and reporting proper (item (a) of the programme of work) had until recently been almost exclusively the main concern of the three groups—the Expert Group, the Intergovernmental *Ad Hoc* Group and the ISAR Group—set up by the United Nations in 1975, 1979 and 1982, respectively, in order to discuss financial information by TNCs. The latter two Groups' conclusions with respect to this type of item have recently been published in a single comprehensive volume entitled *Conclusions on Accounting and Reporting by Transnational Corporations*.[1]

In the course of the sixth and seventh sessions of the ISAR Group, however, the emphasis shifted as the Group's attention was riveted on some of the more action-oriented items ((b) to (d)) of the pro-

[1] United Nations publication, Sales No. E.88.II.A.18.

gramme . None the less, even without any Code of Conduct-related issues to discuss, the Group, during its seventh session, still had to devote considerable time to some rather complex issues of accounting and reporting selected for consideration earlier. In that respect, another shift of emphasis can be discerned. Unlike the situation during many preceeding sessions, the Group focused not so much on specific balance sheet or income statement items as on a number of sophisticated issues of general importance.

Accounting and reporting issues

Selection of discussion items

The topics selected for discussion have been taken predominantly from a rather long list of items identified for future discussion during the Group's 1984 session. Meanwhile, the number of items on that list still to be discussed has considerably decreased over the years. New items can, of course, be added to the list as they are put forward by Member States.

A second source of subjects for discussion may eventually crystallize after finalization of the first international survey (performed by UNCTC as authorized by the Group) of financial statements published by TNCs and other enterprises, particularly when similar reviews with a broader scope would be undertaken at regular intervals. Only preliminary results of the first review were available for discussion during the 1989 session. The Group's report states in this respect that "the survey was an attempt to bring together a massive amount of data for the purpose of examining the availability and comparability of information disclosure".[2] Those familiar with reviewing financial statements will be impressed by the work done by UNCTC as the layout of financial statements world-wide is by no means uniform and the language used to convey a message is sometimes unclear to the extent that the person charged with the survey is unable to state whether the answer to his question is yes, no or not applicable.

The annual review of current developments in the field of accounting and reporting by TNCs, performed on the basis of documentation usually provided by Member States and a number of international governmental and non-governmental organizations, may serve as yet another, a third source of inspiration to supplement the list with fresh topics for future discussion. This is all the more obvious when the input received by UNCTC clearly indicates emerging or already established diverging practices. The 1989 review brought up the following global trends in the field of accounting and reporting which the Group may wish to consider for inclusion in the list: accounting for new financial instruments, the impact of instability in global financial markets and the disclosure of environmental information.

Combination of the concepts of "expert" and "intergovernmental"

Despite the potential contribution from Member States to the process of identifying new items for the discussion of harmonization aspects, there is a danger that the Group might involuntarily commit itself to conclusions already implemented or proposed by Member States and international organizations. Harmonization of divergent practices in the field of accounting and reporting, a key element in the Group's mandate, should not be pursued by endorsing solutions for which there is already a considerable degree of acceptance in practice, since valid, lasting and, above all, politically neutral, internationally convincing expert solutions can only be developed on the basis of a sound economic analysis of the relevant underlying aspects. Of course, in some instances a considerable degree of acceptance may well imply a sound economic foundation, but not necessarily so. In the case of an intergovernmental body like the ISAR Group, however, it is inevitable for the statutorily or otherwise founded national accounting heritage of the several Member States represented therein to have a considerable impact on the discussions. To a certain extent the terms "intergovernmental" and "expert" in the Group's name refer to distinct, not always easily reconcilable attitudes. The term "expert" calls for an unbiased, scientific analysis, whereas "intergovernmental" inevitably introduces a political flavour.

Moreover, a prerequisite for the success of an unbiased approach to harmonization would be that widespread consensus indeed exists on the predominantly economic character of general purpose financial statements. In line with the idea expressed in paragraph 32 of the Group's "Conclusions": financial statements should be prepared for the purpose of enabling the user to form a sound opinion on the financial position and the performance of TNCs. Notwithstanding this agreed conclusion, the existence of such consensus, even within the Group, is by no means beyond doubt. Some, or perhaps many, wittingly or unwittingly, seem to take the view that financial statements should fundamentally not be value-oriented, but rather cash-oriented, upgraded in that some accrual accounting is added. Others, although their numbers are dwindling, are still of the opinion that financial statements should predominantly be based on tax rules. Miraculously enough, it seems that this basic problem has never been explicitly addressed by regional or international bodies, in spite of their deep concern about the reported lack of harmonization in the world-wide field of accounting and reporting.

As will be seen, a rather close connection exists between the above observations and the Group's deliberations on accounting and reporting issues during its seventh session, in particular.

Items discussed

The more important issues selected for discussion during the session included:

- A study on objectives and concepts underlying financial statements;
- Accounting for inflation and changing prices and market and historical values of assets and liabilities; and
- Information disclosure requirements concerning the annual report of the board of directors.

(a) Objectives and concepts

The question of what objectives and concepts are elementary to financial statements has haunted the modern accounting world for a number of years. The type of comprehensive statement encompassing the accounting fundamentals became generally known as a conceptual framework. Consequently, UNCTC, while preparing, as directed by the Group, a report on the subject, could borrow heavily from the preliminary results already available from earlier discussions by other national and international bodies. During its 1988 session, the Group was somewhat reluctant to take up all the proposals worked out by UNCTC. This year, however, with a new text worked out by the Centre, and an informal working party, the remaining obstacles were removed. After a detailed review and some amendments to the UNCTC report, the Group formally adopted the text as amended. The Group agreed that the amended text could be issued by the Centre under the Group's name as a companion publication to the volume encompassing its earlier conclusions.

From the educational point of view, especially in so far as developing countries are concerned, there is clearly some merit for the basics of financial statements to be included in one comprehensive, systematically structured pronouncement. Efforts in that direction may also be particularly valuable in cases where legislators and other standard-setters (while dealing with financial statements) have perhaps been overly focusing on specific balance sheet and income statement items.

Obviously, this article could hardly be an appropriate vehicle for an in-depth commentary covering the 80 odd paragraphs of the Group's conceptual framework — which presumably will not be that much different from future counterparts

[2] See "Report of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting on its seventh session" (E/C. .1989/7).

developed by other bodies. At the beginning of the framework, a few sweeping statements are made, such as "the objective of financial statements is to provide useful information to users" (para. 5), and those objectives "are defined by the needs of users" (para. 6). The term "users" means not only present and potential investors, but also lenders, suppliers, customers, and employees, as well as Governments. On the other hand, the suggestion of apparent open-endedness of the information to be provided in financial statements is somewhat disconcerting. Are needs of users recognized indiscriminately? This is reminiscent of the Group's early sessions, which were to a considerable extent devoted to defining the borderline between general and special-purpose reports: financial statements should be comprehensive in that they contain *and contain only* such information, whether of a financial or a non-financial nature, as is necessary to form a sound opinion of the financial position and the performance of the group (TNC) or of the individual group enterprise, as the case may be (cf. para. 32 of the Group's "Conclusions").

The statement that has my full support can be found in paragraph 11 on what is impressively called the "predictive value and feedback" of financial statements. It is explained that, in financial statements, "the majority of users also require information about the future" and that "information about the past and present performance of the enterprise may be useful in predicting future earnings". Indeed, financial statements should reflect how much better or worse, owing to past and present performances and changes in financial position, a TNC is poised at the start of the new financial year for taking advantage of market opportunities or mastering adverse market trends. In financial statements it is not so much the finish of the current financial year as the start of the next that matters. As the economic aspects of the future crystallize in present values, it looks as if, in the Group's framework, the value-oriented approach prevails.

But this would be jumping to conclusions. From a number of paragraphs it would appear that the framework does not address, nor *a fortiori* take a position with respect to, the dilemma between value or cash orientation. The concept of "future economic benefit", repeatedly used in the context of recognition of assets and liabilities, should not be taken as settling the dispute in favour of value. After all, the wording of paragraphs 34 to 37 on measurement (valuation) is conspicuously neutral with respect to the option between the use of cash-oriented historic cost and the economic concept of current values. It is remarkable that, in those paragraphs—with the exception of paragraph 35 on indexation in highly inflationary conditions—the framework is purely descriptive, whereas in other parts it eagerly states the norm applicable in the circumstances straightforwardly. That does not alter the fact that the description in those paragraphs would appear to be disappointingly deficient in that it ignores the use of current values in other than high inflationary conditions.

(b) Accounting for changing prices

The discussions on the subject "accounting for inflation and changing prices and market and historical values of assets and liabilities" only confirmed the thrust of the paragraphs 34 to 37 of the conceptual framework. They were inconclusive in so far as the antithesis cash- versus value-orientation is concerned. Paragraph 29 of the Group's report reads as follows:

> "Some representatives expressed the wish that the Group could give its support to financial statements that were drawn up using current costs and accept the idea of accounting based on actual values. Others responded that, in the absence of high inflation, they preferred the use of historical cost financial statements because historical cost reflected the actual transactions".

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In paragraph 32 (c), a description is given of the distortion in the financial statements caused by the use of historical costs in a highly inflationary environment. So, presumably, the discussion between the champions of current values and the supporters of historical costs relates not so much to matters of principle as to the more practical question of how far prices can rise without undermining the case of historical costs. None the less, given the fact that historical cost financial statements are the very model of incomparability in that even economically identical assets are included at different amounts depending on the respective dates of acquisition, the Group missed one of the very few significant opportunities left to make an essential contribution to harmonization worldwide. The Group did develop guidelines, however, for accounting in hyperinflationary economies, that is, economies in which a cumulative rate of inflation of about 100 per cent is reached over a period of three consecutive years. Let us hope that this part of the Group's report (paragraph 32, subparagraphs (a) to (q), though at present very relevant to a number of Member States, will soon have only historical value.

(c) Directors' report

From the discussions of the directors' report, the third selected item, it appeared that the practice of complementing the financial statements of a TNC by a report of its directors is already widespread. Such a report, according to the Group, had the potential of providing policy and future-oriented information. Without difficulty the Group reached consensus on the conclusion that the directors' report could usefully include discussion and analysis by the directors of business activities as a whole (corporate review), a more detailed view of the activities of individual segments (segmental review) and a review of financial results and the financial position (financial review). A clear distinction should always be made, however, between information to be disclosed in the notes to the financial statements, required to make them comprehensive, and that which can appropriately be included in the directors' report. Each of those documents has its own special objective, and the information to be included is not simply interchangeable. A chairperson's statement (if provided, because it is unknown to many jurisdictions) should, according to the Group, serve as an additional element of the directors' report.

For each of the above three review classes, the Group agreed on a number of more specific details that should preferably be disclosed. Most of those tune in to the reporting practices already adopted by some leading TNCs, such as the requirement to discuss corporate strategy, future prospects, research and development, investment programmes, and environmental and public safety aspects. The idea of a comprehensive segmental review, focusing on business as well as on geographical segments, will probably not be immediately welcomed by the business community world-wide. European Community law, for example, is much more liberal in that respect. Under those circumstances, it was quite obvious that there was sympathy, but not consensus, in the Group for immediately endorsing the plea by UNCTC for even more details, particularly on foreign direct investment, to be provided in financial statements, directors' reports and special-purpose reports.

Action-oriented discussions

The development of relations with Governments, regional and international, intergovernmental or non-governmental organizations, TNCs, professional organizations active in the accounting sector, as well as with any person or group of persons interested in the Group's work has been a matter of concern to the Group. As compared with the public relations offensive by some accounting standard-setters, the Group has always been extremely peaceful. As a matter of fact, it does not

even wish to set standards, but only to provide guidance to legislators, other standard-setters, TNCs and other interested parties. Special attention to the public relations aspect will need to be paid by UNCTC, which has already been responsible for the provision of background material and all other information about the Group. A special promotional brochure on the Group's activities has now become available to all interested parties.

Promotional efforts among Governments of States Members of the United Nations are specially needed to stimulate further interest in participating in the Group's work. Membership in the Group should be encouraged. The Group has suggested to the Commission on Transnational Corporations the establishment of a special trust fund to defray the cost of participation by representatives of developing countries. The Commission requested the Centre to prepare more detailed plans for the institutional, organizational and operational aspects of such a fund.

Recently, the Group has also become concerned about making its know-how available to others. The suggestion that the African countries be assisted in accounting education, research and practical training, which was first brought up in one of the meetings of the sixth session, was discussed in greater detail during the 1989 session. Meanwhile, useful information has been provided on the present situation and possible needs of the continent. The Group was informed that the London-based Chartered Association of Certified Accountants had deployed educational activities in Africa over a long period of time and had gained valuable experience. More recently, the Fédération Internationale des Experts-Comptables Francophones became active in the field. Therefore, the Group, recognizing that those important efforts by these and other organizations deserved support, requested UNCTC to prepare for its next meeting a feasibility study on the subject in which all relevant particulars of the African accounting environment would be examined.

Recently, a number of centrally planned economies decided to introduce gradually selected elements that are typical for developed market economies. That has boosted the interest in those countries with regard to market-oriented accounting and reporting. In the wake thereof, appreciation of the Group's work has steadily increased. In June of this year, a successful workshop was held in Moscow, organized by the Centre and the USSR Chamber of Commerce and Industry, on accounting for and by East-West joint ventures in centrally planned economies. As a result of the workshop, the USSR Ministry of Finance has resolved a number of accounting problems, and arrangements have been made for an international task force to make recommendations to the Ministry regarding the remaining problems troubling foreign partners.

The eighth session of the Group will presumably produce further developments in the area of education and transfer of accounting know-how. However, the Group will continue its traditional discussions on accounting and reporting issues — an element of its mandate. In 1990, the Group will discuss the following selected subjects on the basis of documentation to be provided by the Centre:

- Information disclosure relating to environmental measures;
- Accounting for and by joint ventures; and
- Accounting for intangible assets, including goodwill, software etc.

Concluding remarks

The account of the Group's action-oriented activities is much shorter than that concerning the more theoretical accounting and reporting issues. Perhaps the relevant sections are, in some respects, inversely proportional to the immediate importance of the two categories. Recently, a survey undertaken by the Centre of compliance by TNCs with international standards showed that much remained to be done. Those who remember the many controversies during the Group's early days will certainly recognize with satisfaction that, despite still open questions, there is now apparently widespread intergovernmental consensus on the merits of market-oriented accounting laid down in the Group's publications entitled *Conclusions on Accounting and Reporting by Transnational Corporations* (ST/CTC/92) and *Objectives and concepts underlying financial statements* (E/C.10/AC.3/1989/8). That achievement comes just in time now that the idea of market-oriented economic policy seems to be very much in vogue world-wide. In a sense, the past decade can appropriately be seen as the forerunner necessary to creating an adequate basis from which the action-oriented activities can be launched. The best way for the Group to become more influential would appear to be to address actively the accounting and reporting needs of Governments and intergovernmental bodies and avoid lengthy discussions of financial statement items.

That is why the activities of the Group call for careful consideration, during the ninth session in 1991, when the renewal of the Group's mandate will be discussed. In a future mandate, the key elements should probably be the Group's platform function and transfer of accounting know-how through the intermediary of UNCTC. □

Commission on Transnational Corporations
Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting
Eighth session, New York, 13-23 March 1990

Documentation

E/C.10/AC.3/1990/1	Provisional agenda
E/C.10/AC.3/1990/2	Report of the Secretary-General on the review of important current developments at the global level in the field of accounting and reporting by transnational corporations
E/C.10/AC.3/1990/3	Report of the Secretary-General on the review of important current developments at the national level in the field of accounting and reporting by transnational corporations
E/C.10/AC.3/1990/4	Report of the Secretary-General on the international survey of financial statements published by transnational corporations and other enterprises
E/C.10/AC.3/1990/5	Report of the Secretary-General on information disclosure relating to environmental measures
E/C.10/AC.3/1990/6	Report of the Secretary-General on appropriate measures to give effect to the work of the Group
E/C.10/AC.3/1990/7	Report of the Secretary-General on accounting for pension commitments
E/C.10/AC.3/1990/8	Report of the Secretary-General on accounting for and by joint ventures
E/C.10/AC.3/1990/9	Report of the Secretary-General on accounting for intangible assets
E/C.10/AC.3/1990/10	Report of the Secretary-General on further steps to be taken in relation to the development of the comprehensive information system
E/C.10/AC.3/1990/11	Report of the Secretary-General on ways and means of improving education, research and practical training in the field of accounting and reporting in Member States: results of the survey relating to Africa

CONTRACT NEGOTIATIONS

Contract stability in international petroleum operations

By Roland Brown, UNCTC

The views expressed are those of the author and do not necessarily represent those of the United Nations.

The investment climate in most developing countries is today very different from the prevailing climate at the beginning of the last decade. Harsh confrontational attitudes were common in the 1970s, and were often a significant factor complicating negotiations in natural resource projects. Today the mood is more benign, and many, perhaps most, developing countries now believe that a new generation of agreements can ensure that investment by mining and oil companies is consistent with the prudent long-term management of non-renewable resources.[1]

The change in mood, which is based on a recognition that there can be a mutuality of interest, does not, of course, mean that difficulties in negotiating exploration and production agreements in the petroleum industry have been eliminated. Indeed, the truth is quite the reverse. Where foreign investment was seen as a threat to national sovereignty, and the only proper response outright hostility, there was often, as a corollary, disdain for, or at least scepticism about, the idea that contract terms negotiated with an oil company could make the difference between a good deal and a bad one. Now that doctrinaire prescriptions have given way to some pragmatism, developing country negotiators are attaching more and more importance to what actually happens around the negotiating table. However, the search for the right agreement generates complications, and a proper balance between interests of investors and Governments of host countries may require increasingly intricate provisions.

At the heart of any negotiation about an exploration and production agreement is the fiscal régime which, in the event of a commercial discovery, will determine how the surplus generated by the project will be divided between the State and its agencies, on the one hand, and the oil company on the other. Under present-day conditions, that involves more than taxes and royalties. In order to determine the fiscal régime, it may also be necessary to reach agreement on State participation, the terms and conditions for a carried interest (if any) and, of course, in production-sharing contracts, on the provisions for cost recovery and the division of profit oil. All of these matters can be difficult and will pre-empt most of the time available for negotiation. However, on both sides of the negotiating table there will be an appreciation that reaching agreement on fiscal terms would be an empty gesture unless the contract could accord to those terms at least some degree of stability. Stability of contract terms is, therefore, the lurking presence at all exploration and production negotiations and must be recognized and confronted by the parties before their deal is concluded.

In the present article, consideration is given to what is really meant by stability of contract terms, and an attempt is made to assess how far oil companies can or should go in seeking effective assurances from Governments of host countries. In that context, the first point to stress is the complexity of the subject. There is no lazy man's one-liner which can be slotted into place to achieve the right result. "The Government hereby guarantees the stability of the terms set forth in this Agreement." Most contract negotiators have seen, and some of them may even be responsible for, formulations of that kind. The words have a satisfying sound about them, but what do they mean? A firm edifice of stability cannot be built on the basis of a jurisprudential conundrum. The truth is that the issue of stability has many different dimensions and the problem of finding a *modus vivendi* will not yield to any facile solution.

Perhaps the best way of getting a general view of the problem is to look at some of the specific questions that are discussed at the negotiating table in the context of oil company concerns about the stability of contract terms.

The status of the contract

Some oil companies have sought to establish a special status for an exploration and production agreement by proposing that it should be ratified by an Act of Parliament and take effect as part of the law of the host country. Such proposals have met with a mixed response. Many Governments have rejected them out of hand, while some others have been prepared to accept them; in a few countries, ratification by Parliament is, in any event, established practice in the case of major investment projects.[2] Oil companies generally propose ratification as a way of ensuring over the long term that the provisions of an agreement are observed. It is not easy, however, to understand why ratification should be seen as having that effect. In most countries, what the legislature has enacted the legislature can repeal or amend and, once the spectre of legislative competence has been invoked, there can be no certain way of ensuring that it is confined within the ambit of provisions already agreed between the Government of the host country and the foreign investor.[1] Of course, what oil companies would like would be for an exploration and production agreement to take effect in the law of the host country as a constitutional amendment protected by entrenchment from abrogation or erosion. Fortunately,

[1] For a review of changing trends, see "Relations between host developing countries and transnational corporations", in *Transnational Corporations in World Development: Trends and Prospects* (United Nations publication, Sales No. E.88.II.A.7), chap. XIX, pp. 313-329.

[2] In Sierra Leone, all major agreements relating to petroleum and mining projects are ratified by Parliament and published as a schedule to the Act. In Papua New Guinea, agreements covering two large-scale mining projects, Bougainville and Ok Tedi, were ratified by Act of Parliament. However, a more recent agreement relating to the development of a gold mine on Misima Island was not, and it is understood that the practice of embodying mining agreements in legislation has now been discontinued.

most companies are realistic and appreciate that, even in the case of a pliant Government, there is small chance of achieving any such result. In practice, ratification by Parliament may have the advantage of ensuring that undertakings set forth in an agreement cannot subsequently be found to be *ultra vires* by reason of some antecedent statutory provision overlooked or misconstrued at the time the agreement was concluded. That, however, is not normally a major concern, and ratification by legislative instrument should be seen as only marginally relevant to the issue of stability.

Renegotiation

An exploration and production agreement is a long-term commitment and, in view of the bewildering uncertainty about predicting the movement of costs and prices, many developing countries believe that provision for renegotiation is an essential feature of any satisfactory agreement.[4] Host country concern with this issue is sometimes reflected in statutory provisions which require the inclusion in agreements of a review clause.[5] Looking this time at the oil companies, we find again a mixed response. Some companies consider that a provision for review or renegotiation inevitably undermines stability and raises a basic issue of principle which must engage the attention of management at the highest level. The response of other companies is more relaxed. Provided appropriate language has been used, a review or renegotiation clause is seen for what it is: an agreement to agree; at worst, providing the Government of a host country with some occasion for harassment in the future, but not a great engine for change capable of undermining the stability of contract terms. Differences of view on that issue are increasingly unlikely to be a major stumbling block in the negotiation of an exploration and production agreement. Greater flexibility on the side of the oil companies is generally matched by a growing scepticism among developing countries about the value of such clauses. Where a host country believes that a basic change in economic conditions requires some adjustment to contract terms, what is to happen if, under a review clause, no agreement can be reached between the parties? Neither side will wish to invoke international arbitration, which is not appropriate to the settlement of a dispute devoid of juridical content. For both sides, the issue will be one of "justice" or "fairness" and, in a commercial context, there are really no accepted ground rules about those matters to which an arbitrator can make reference. Increasingly, therefore, developing countries see a clause

[3] This difficulty was perceived very clearly by the draftsman of the Bougainville Copper Agreement, 1967, who made a brave if rather puzzling attempt to grapple with the consequences. The Agreement provided that the Administration would introduce an Ordinance to ratify the Agreement and give it the force of law. Then, referring to the proposed legislation, it went on as follows:

"If such Ordinance comes into effect as aforesaid but at any time thereafter such Ordinance is expressly or impliedly amended or repealed or this Agreement is expressly or impliedly varied added to cancelled abrogated or deprived of any of the force or effect which it has upon the coming into effect of such Ordinance (except as provided by the Ordinance or this Agreement, or with the prior consent of the Company), then irrespective of whether such amendment repeal variation addition, cancellation abrogation or deprivation would otherwise constitute a breach of this Agreement the Company the members of the Company and the beneficial owners of shares in the Company shall in respect of the same have all the rights and remedies which it or they would have as if the same were a breach of this Agreement by the Administration".

The laws of Papua New Guinea, Ordinance No. 70 of 1967 (the Schedule). As a result of negotiations which took place in 1974, the Agreement has been substantially amended. However, this particular provision remains unaltered. For an account of the changes made in the fiscal régime, see M. L. O. Faber, "Bougainville renegotiated: an analysis of the new fiscal terms", *Mining Magazine* (December 1974).

[4] The position of developing countries on this point has attracted a good deal of support. The Group of Eminent Persons appointed by the Secretary-General of the United Nations, in The Impact of Multinational Corporations on Development and on International Relations (United Nations publication, Sales No. E.74.II.A.5), p. 38, stated that:

"While a clear understanding on various issues at the time of entry is vital, it has to be recognized that conditions change, and that what may have seemed to be adequate and fair at the time of entry may prove unsatisfactory to either party over time.

A large number of agreements made in the past lack comprehensiveness and contain no provision for renegotiation. Developing countries have, of course, the power, through legislation, to modify the terms of agreements. But sometimes such actions, if carried out unilaterally, entail disproportionally high costs in terms of the future flow of investment. A willingness on both sides to renegotiate agreements which have been in force for more than, say, 10 years, could help to avoid recourse to extreme measures.

The *Group recommends* that in the initial agreement with multinational corporations, host countries should consider making provision for the review, at the request of either side, after suitable intervals, of various clauses of the agreement".

See, also, the draft Code of Conduct on Transnational Corporations, *Official Records of the Economic and Social Council, 1983, Supplement No. 7* (E/C.10/1983/S/5/Rev. 1), annex II, para. 11, which reads as follows:

"Contracts between Governments and transnational corporations should be negotiated and implemented in good faith. In such contracts, especially long-term ones, review or renegotiation clauses should normally be included.

"In the absence of such clauses and where there has been a fundamental change of the circumstances on which the contract or agreement was based, transnational corporations acting in good faith, shall/should co-operate with Governments for the review or renegotiation of such contract or agreement."

[5] Section 13 of Ghana's *Petroleum (Exploration and Production) Law*, 1984 reads:

"A petroleum agreement shall provide for a review of its terms at any time any significant change occurs in the circumstances prevailing at the time of the entry into the agreement or the last review of the agreement".

Most companies would find it easier to accept periodical review at stated intervals. See, for example, article 26a of the amended *Bougainville Copper Agreement*, which reads as follows:

"The parties shall co-operate with each other in carrying out the purposes of this Agreement and shall meet together during the seventh year after the year in which the Amendment Date occurs, and at intervals of seven years thereafter, with a view to considering in good faith whether this Agreement is continuing to operate fairly to each of them and with a view further to discussing in good faith any problems arising from the practical operation of this Agreement. If at any such meeting it is agreed that this Agreement is not so continuing to operate fairly to each of the parties, or the parties agree that there exist problems arising from the practical operation of this Agreement, then they shall confer together in good faith in an endeavour to ensure that this Agreement shall operate fairly to both of the parties or to resolve such problems (as the case may be) and, in particular, and without prejudice to the generality of the foregoing, they shall use their best endeavours to agree upon such changes to this Agreement as may be requisite in that regard."

providing for renegotiation as no more than a begging bowl which, if other circumstances are favourable, may help to stimulate a little generosity.[6]

Among developing countries, scepticism about the value of review clauses has resulted in a growing interest in the possibility of finding a more flexible fiscal régime which would be capable of responding within the terms of the contract itself to a wide range of economic variables. This may be the real key to stability, and that theme is examined again in the present article in the context of the specific undertakings about the fiscal régime which companies generally require from Governments of host countries.

The governing law of the contract

The desire of foreign investors in the oil industry to achieve an enclave status for exploration and production agreements has given rise to a set of issues connected with the governing or, as it is sometimes called, the proper law of the contract. Efforts to achieve an enclave status derive from the perfectly natural concern of oil companies that the Government of the host country will, as a sovereign entity, exercise its legislative competence to abrogate or erode by unilateral action the terms previously agreed. In that context, there has been a search for some magic words about the governing law which will build a rampart of stability around the agreement. In practice, the discussion of different formulations gives rise to rather abstruse conceptual problems of considerable academic interest, but difficult for most contract negotiators to handle with any assurance.

For many English lawyers looking at this issue, the starting point is now likely to be the rather famous *dictum* of Lord Diplock in the *Amin Rasheed* case.[7] Cutting through to the roots of contractual liability, he said,

> "My Lords, contracts are incapable of existing in a legal vacuum. They are mere pieces of paper devoid of all legal effect unless they were made by reference to some system of private law which defines the obligations assumed by the parties to the contract by the use of particular forms of words and prescribes the remedies enforceable in a court of justice for failure to perform any of those obligations".

These very down-to-earth words raise problems about the construction of a number of governing law clauses to be found in exploration and production agreements. If, as Lord Diplock says, a contract has life only because it is made within a system flaw which defines obligations and prescribes remedies, what are we to make of the so-called "frozen law"clauses, which refer to a body of rules which may no longer exist because they have been repealed or amended by subsequent legislation.[8] How, again, should we construe the patchwork quilt of different colours which the unfortunate arbitrators had to struggle with in the Texaco Case[9] and the other arbitrations involving the Libyan Arab Jamahiriya.[10] Of course, Lord Diplock's plain words may be wrong or misleading. Perhaps we should be considering the possibility that a contract can create its own proper law,[11] or that somewhere out there in the firmament there is an evolved, or evolving, *Lex Mercatoria*,[12] which will serve to create an internationalized enclave for exploration and production agreements.

In an area where there are so many elusive conceptual problems, only the brash and self-confident will be sure they have the right answers. These are matters which are going to be talked and written about for years before any genuine consensus emerges. In the meantime, focus on the governing law will continue to produce a fine crop of riddles and puzzles, but is unlikely in isolation to be the key to greater contractual stability. Fortunately, there are very few, if any, developing countries which would assert that they have an unfettered right by the exercise of legislative competence to abrogate or amend a contract to which the Government is a party. On the other side, most oil companies recognize that an exploration and production agreement made with the Government is not a treaty between sovereign States and the maxim *pacta sunt servanda* cannot be invoked to emasculate totally the regulatory power of the Government of the host country. If rights under an agreement made with a foreign investor are seen as species of property, the issue is whether, in any particular case, interference with those rights amounts to expropriation,[13] for which the State may incur international responsibility if appropriate compensation is not paid. That is a matter which, in the end, must be resolved by reference to evolving rules of public international law.[14] The task for the international lawyer of distinguishing between regulation (the police power in the constitutional law of the United States) and the taking of property for a public purpose is a difficult one.[15] Serious discussion of that problem, however, is worth while, and likely to have more positive results than trying to make sense of a collection of semantic variables to be found in governing law clauses.

[6] For a more extended discussion of this issue, see Roland Brown, "The relationship between the State and the multinational corporation in the exploitation of resources", *The International and Comparative Law Quarterly*, vol. 33 (1984), pp. 225-227.

[7] *Amin Rasheed Shipping Corp. v. Kuwait Insurance Co.*, 1983 All. ER, 884.

[8] One way in which the conceptual problems associated with the application of the so-called frozen law clauses can be resolved is to treat them as cases of incorporation. If that approach is adopted, the parties, in spite of their apparent intention as evidenced by the language of the contract, are said not to be concerned in such clauses with the choice of a governing law. This seems to be the view of Georges R. Delaume, who says that a reference to a particular law in force at the time of contracting "by all relevant canons of interpretation cannot be construed as a choice of law provision" (see *Legal Aspects of International Lending and Economic Development Financing*, published for the Parker School of Foreign and Comparative Law, Columbia University, by Oceana Publications, Dobbs Ferry, New York, 1967, pp. 84-85). Those remarks were made by the author in the context of early World Bank agreements which were to be interpreted in accordance with the law of New York "as in effect at the time of the agreement". They are, in effect, repeated by Delaume in *Transnational Contracts*, vol. 1 (1981), chap. II, p. 2.07. Prepared under the auspices of the Parker School of Foreign and Comparative Law and published by Oceana Publications (Dobbs Ferry, New York).

[9] *Texaco-Libya* 53 ILR 389. The clause reads as follows:

"This Concession shall be governed by and interpreted in accordance with the principles of law of Libya common to the principles of international law and in the absence of such common principles then by and in accordance with the general principles of law, including such of those principles as may have been applied by international tribunals".

[10] *BP-Libya* (1979) 53 ILR 297, *Liamco-Libya* (1981) 62 ILR 140. The arbitrators in the three cases involving the Libyan Arab Jamahiriya missed an opportunity to clarity the role of the governing law in concession agreements. While no one is likely to be surprised by the result in those cases, reading the awards creates an impression of some intellectual disorder.

[11] Generally speaking, the idea has not been well received. F. A. Mann has described it with unusual severity as "doctrinally so unattractive, so impracticable, so subversive of public international law, so dangerous from the point of view of legal policy and so unnecessary that its novelty will not cause surprise". (See "The proper law of contracts concluded by international persons", *British Year Book of International Law*, 35 (1959), p. 49.

Finality in fiscal terms

Finally, there is the all-important issue of stability for the fiscal régime. What assurances should the Government of the host country be asked to give in order to establish for the fiscal terms the degree of finality which the investors may reasonably require? In the mood of realism which marks the new investment climate, nearly all developing countries could be said to have come to terms with two basic propositions:

(a) Before an oil company will spend any substantial sums on exploration, it must be satisfied that, in the event of a commercial discovery, the fiscal régime will permit the company to earn what it regards as an appropriate rate of return on the capital invested in exploration and development;

(b) In order to predict a rate of return, the company must be able to calculate the financial out-turn — the cash flow from the project. This necessarily implies a fiscal régime which will remain stable during the assumed life of the field or fields. That, in turn, requires effective guarantees that there will be no new taxes or duties and no increase in existing rates which will radically alter the assumptions about costs and profits on which the original investment was based.

Coming to terms with those propositions necessarily implies that a developing country will be ready to give contractual undertakings which will ensure that no significant part of the fiscal régime remains open-ended. Nearly all developing countries are prepared to do that,[16] but subject generally to two important qualifications:

(a) The undertakings given by the Government must be in a form which is consistent with the host country's legal and constitutional requirements. In most countries with a parliamentary system, there is no way in which the executive can give binding commitments about taxes or rates of taxation in the future. However, where that difficulty arises, it can generally be overcome by some relatively simple expedient, which does not evoke problems about parliamentary sovereignty. For example, where income tax rates are increased beyond the level prescribed, the Agreement may provide that the additional amount due will be paid on behalf of the foreign investor by a national oil company. Alternatively, where there is a tax increase which adversely affects the oil company investor, the agreement may require that other parts of the fiscal régime should be adjusted in order to ensure that there is no effective change for the foreign investor in the aggregate of benefits and burdens;

(b) The fiscal régime as a whole must be sufficiently flexible to ensure that it will be capable of responding within the terms of the contract itself to a wide range of economic variables. No developing country can or should be asked to guarantee over the life of the project the stability of a fiscal régime which is insensitive to major variations in costs or prices or to the size and productivity of producing fields. There are many different ways in which the required flexibility can be achieved, some more controversial than others. One approach is to introduce into profit-sharing the concept of a discounted cash flow rate of return.[17] Alternatively, a roughly similar result may be achieved by using, in the determination of profit shares, a formula based on the relationship between cumulative net cash flows and cumulative capital expenditure. In some other cases, physical criteria may be more appropriate, for example, a variable royalty related to an index of well productivity. Whatever the methodology, a flexible, responsive fiscal régime is an *irreducible* requirement if effective, across-the-board guarantees of fiscal stability are to be given and honoured by developing countries. Some oil companies are reluctant to forgo the prospect, however remote, of an extravagant, upside bonanza, but they need to remember that the goal of contractual stability may not be attainable by companies unwilling to pay the asking price.

Quite apart from those important qualifications, it must also be understood that very few developing countries are willing to give binding contractual guarantees for stability which extend beyond the specifics of the fiscal package. Some oil com-

[12] This notion (the *contrat anational*) has also incurred the displeasure of the redoutable Dr. F. A. Mann. For his strictures, see *The International and Comparative Law Quarterly*, vol. 33 (1984), p. 196. For another negative view, see Georges Delaume, "The proper law of state contracts and the *lex mercatoria*: a reappraisal", *Foreign Investment Law Journal*, vol. 3, No. 1 (1988).

[13] This was the underlying question which the arbitral tribunal had to consider in *Revere v. OPIC* 56 ILR 258, where the meaning of "expropriatory action" in an *OPIC* (Overseas Private Investment Corporation) insurance contract was at issue. For a discussion of this case in the context on "indirect takings", see Rosalyn Higgins, "The Taking of Property by the State: Recent Developments in International Law", The Hague Academy of International Law, vol. 176 (1982-III), Recueil des Cours, pp. 347-354.

[14] Many developing countries recognize the role that must be accorded to international law in this context. There is generally, therefore, a willingness to accept a choice of law provision based on article 42 of the Convention on The Settlement of Investment Disputes between States and Nationals of Other States. So far as relevant, it reads as follows:

"The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable".

That concept was elaborated in an interesting choice of law clause in the amended Master Agreement for the Valco River Project in Ghana. It reads as follows:

"This Agreement shall be governed by and construed in accordance with the law of Ghana and such rules of International Law as may be applicable. The parties hereto acknowledge and agree that the legislative competence of Ghana as a sovereign State is defined by its applicable constitutional instruments and can be exercised only within the limits ordained by established rules of International Law. The term 'International Law' as used in this Article should be understood in the sense given to it by Article 38 (1) of the Statute of the International Court of Justice, allowance being made for the fact that Article 38 aforesaid was designed to apply to inter-State disputes."

For an account of the renegotiation of this project, see Fui S. Tsikata, ed., *Essays from the Ghana-Valco Renegotiations 1982-'85* (Ghana: Ghana Publishing Corporation, 1986).

[15] Rosalyn Higgins, not easily daunted by apparent difficulties, finds "the underlying policy difference hard to appreciate", *op. cit.*, p. 330. That may well be so, but it is sanctioned by a large body of United States case law.

[16] In a limited sense, Papua New Guinea is an exception. The Government has resolutely refused to give any guarantee that there will not be an increase in income tax rates during the life of the project. However, the State does guarantee that there will be no discrimination against the licence-holder in the levying of taxes and, in a country in which there are growing numbers of mineral-based projects, that is seen by most companies as an effective assurance.

[17] In its most familiar form, this is the so-called Resource Rent Tax. The classic exposition of the concept is an article by Ross Garnaut and A. Clunies Ross, entitled "Uncertainty, risk aversion and the taxing of natural resource projects", in *The Economic Journal*, vol. 85, No. 338 (June 1975), pp. 272-287. See also Ross Garnaut and Clunies Ross, *Taxation of Mineral Rents* (Oxford University Press, 1983), and Christopher Gross, *Petroleum and Mining Taxation: Handbook on a Method for Equitable Sharing of Profits and Risk* (London, Royal Institute of International Affairs, 1986).

panies, pushing the logic of their position to the frontier of acceptability, ask Governments to agree that, in the event of any legislative change which adversely affects the economics of the project, the Government will, by exemption, excuse the company from compliance, or, where that is not possible, make compensating adjustments to the fiscal terms. Most Governments of host countries would see a request for such guarantees as raising an issue of principle. A fiscal guarantee is one thing; a broader guarantee, which would accord to oil company operations a kind of diplomatic status, is something else altogether. No responsible Government, whatever its ideology, can undertake that future legislation on social and environmental issues will not result in an increase in business costs. If an increase in business costs is inevitable, Governments of host countries ask why oil companies should receive special protection. They are long-term investors. Why should they not, with others, make their contribution to the cost of developing, sustaining, and protecting an evolving society? Of course, there is a danger that, in a poor or small country, a single petroleum project, if it is sufficiently profitable, might find itself called on to finance what an English judge once referred to as "eccentric principles of socialistic philanthropy".[18] If that is seen as a real danger, oil companies should seek contract terms which will ensure that they are protected against legislation which discriminates, or has the effect of discriminating, against them.[19]

[18] Roberts v. Hopwood [1925], A.C. 578 per Lord Atkinson at page 594.

[19] There are, of course, conceptual problems about formulating an effective non-discrimination clause in the context of an isolated or unique project. However, they are not necessarily insuperable.

Conclusion

This brief review of the stability issue may suggest that reaching agreement on an exploration and production contract satisfactory to both sides is going to be hard work. Certainly there is no primrose path to harmony. If future problems are to be avoided, the hard issues have to be identified and tedious negotiations must be carried out to find solutions acceptable to both sides. There is now good reason, however, for optimism about the end result. Much heavy, hard-to-carry ideological baggage has been discarded and a rather hard-nosed pragmatism characterizes the posture of most developing countries. That is something which oil companies should not find it too difficult to accommodate. After all, it is within the scope of their experience and does not run counter to any of the accepted values which make up their corporate ethos. □

Just published *(continued from p. 46)*

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